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COMPREHENSIVE TAX REFORM: PROSPECTS AND CHALLENGES

HEARING

BEFORE THE

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UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

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COMPREHENSIVE TAX REFORM: PROSPECTS AND CHALLENGES

TUESDAY, JULY 18, 2017

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

The hearing was convened, pursuant to notice, at 9:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Crapo, Enzi, Thune, Isakson, Portman, Toomey, Heller, Scott, Cassidy, Wyden, Cantwell, Nelson, Menendez, Carper, Cardin, Brown, Bennet, Casey, Warner, and McCaskill.

Also present: Republican Staff: Mark Prater, Deputy Staff Director and Chief Tax Counsel; Tony Coughlan, Tax Counsel; and Chris Hanna, Senior Tax Policy Advisor. Democratic Staff: Joshua Sheinkman, Staff Director; Tiffany Smith, Chief Tax Counsel; and Ryan Abraham, Senior Tax and Energy Counsel.

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

The CHAIRMAN. The committee will come to order. Welcome, everyone, to our first hearing of the day, where we will discuss the ongoing effort to reform our Nation's tax code.

We have a distinguished panel of bipartisan experts before us today to help shed some light on issues surrounding tax reform. I look forward to a productive discussion and appreciate your attendance, and you are here a bit earlier than our normal meeting time.

In 1984, President Reagan called for a reform of the tax code. He laid out three main goals for tax reform: fairness, efficiency, and simplicity.

Those three goals are as relevant today as they were a generation ago. For our current efforts, I would add a fourth goal: American competitiveness. This goal is essential in today's global economy, as we must also consider what is happening outside our borders.

When discussing tax policy or legislation, it is very easy to find oneself heading down byzantine paths of complexity, but I think we would do well to keep focused, and to frequently remind ourselves of these basic principles. Therefore, I will repeat them: fairness, efficiency, simplicity, and American competitiveness.

The Tax Reform Act of 1986 is generally considered to be a great success. However, one question people should ask themselves is, if

the law we passed in 1986 was such a success, why did it disintegrate so quickly?

Obviously, there are a number of competing interests out there, with many of them focused on narrow provisions or benefits in the tax code. Some of these interests have employed efficient lobbyists to make compelling cases for changes, while others have elected efficient legislators who have done the same. That is one reason for the more or less constant change we have seen to the tax code since 1986.

Another reason might be that the theoretical underpinnings of the 1986 bill were not as sound as many assumed. For one thing, the 1986 reform was a shift towards pure taxation of income. But in the last couple of decades, there has been an increasing awareness of the efficiency of taxing savings and investment lightly—or not at all—and instead basing the tax system on consumption.

And indeed, a number of the subsequent changes to the tax code would be described as a shift away from taxing income toward taxing consumption. This helps to explain things like decreased tax rates on capital gains and dividends, more rapid depreciation schedules, and more qualified retirement plan options.

Many of the major reform proposals we have seen in recent years—including the House's Better Way Blueprint—would take us further in that direction. And while some of these changes have been very good, the piecemeal fashion in which they have happened was not consistent with simplicity. And many of the changes have been bad, in my opinion.

Another way of looking at the unraveling of the 1986 tax reform law is that it had a sound theoretical basis at the time, but technological changes in the intervening decades have required us to make changes in the years since. For example, the tax base is far more mobile today than it was in 1986. And a mobile tax base is inherently less reliable, making efforts to heavily tax highly mobile assets an exercise in futility.

Whatever the case, we know that the myriad changes to the tax code in the past 3 decades have left us with a status quo that is simply unsustainable. American families, individuals, and businesses collectively spend hundreds of billions of dollars a year—not to mention countless hours—simply trying to comply with our tax code.

Tepid growth rates for the U.S. economy have seemingly become the new normal for some. America's multinational businesses find it difficult to compete abroad and are often targets for acquisition by foreign companies.

All of this should be very unacceptable to every member of the Senate. Senator Wyden was correct when he recently described the current tax code as a "rotting economic carcass."

There is no longer any question as to whether we should reform the tax code. The only questions remaining are "how?" and "when?"

For this reason, we are engaged in a long-term effort to fix these problems. And in my view, the momentum in favor of comprehensive tax reform is stronger now than at any point since the 1986 reform was signed into law.

I know Republicans, both on this committee and elsewhere, are united in our commitment to fix our broken tax system, and efforts

in both chambers of Congress and on both sides of Pennsylvania Avenue are ongoing. My sincere hope—which I have repeated numerous times—is that our Democratic colleagues will be willing to join in this effort.

Tax reform should not have to be a partisan exercise. Indeed, the negative impact of the status quo falls on Republican and Democratic voters alike. So we should all be willing to work toward solutions.

I know that many of my colleagues on the other side of the aisle recognize the need for reform. However, much of the Democratic leadership's rhetoric on this issue has been less than encouraging.

We have heard condemnations and claims about tax plans that do not yet exist. We have heard demands—sometimes stated as preconditions to any bipartisan cooperation—for concessions that are unrelated to tax reform. And on a similar note, we have heard demands that Republicans make significant procedural concessions for moving a tax reform bill as a prerequisite for any bipartisan engagement on the substance of potential legislation.

I will not belabor this issue too much at this point. I will simply say that, historically speaking, this is not how we have worked on bipartisan tax policy, and I hope that the statements we have heard from some of the Senate Democratic leaders discouraging bipartisan efforts on tax reform do not reflect the views of all our Democratic colleagues.

Today, we have a panel of four very skilled experts who represent both parties. They are all former Assistant Secretaries of Treasury for Tax Policy. They have been on the front lines of tax policy for some time, and I am certain that their insights can help us today as we work to address both the shortcomings of our current tax system as well as the divisions that could hamper our tax reform efforts.*

And with that, I am very pleased to turn to my colleague and partner, Senator Wyden.

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

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

Senator WYDEN. Thank you, Mr. Chairman. And on this side, we very much would like to work in a bipartisan way and have a true partnership on this issue for a tax code that gives all Americans the chance to get ahead.

I want to begin by saying that everyone here wishes Senator McCain a full and speedy recovery. John McCain is about as tough as anybody around, and with Cindy, his wife, in his corner, we are all counting on him being back with us soon.

Mr. Chairman and colleagues, it is hard to imagine a member of Congress, Democrat or Republican, who would stand up before a crowd at a business or town hall meeting at home and say, "I am a big fan of the tax system on the books." Insanely complicated, riddled with sweetheart deals, and plagued by the inversion virus,

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*For more information, *see also,* "Overview of the Federal Tax System and Policy Considerations Related to Tax Reform," Joint Committee on Taxation staff report, July 14, 2017 (JCX–36–17), *https://www.jct.gov/publications.html?func=startdown&id=5015*.

I just do not see a lot of members of Congress out there stumping for business as usual tax policy.

What is needed is bipartisan tax reform that focuses on progressivity and helping the middle class, cleaning out the flagrant tax loopholes, fiscal responsibility, and giving all Americans the chance to get ahead. Now, those were all key principles of what happened 3 decades ago when Democrats and Republicans got together for major bipartisan tax reform.

Unfortunately, in the first months of this administration, the majority party has not shown any concrete interest in this kind of approach. Before his confirmation, Secretary Mnuchin embraced what has come to be known as the Mnuchin Rule—no absolute tax cut for the wealthy.

I think it would be fair to say that stirred a lot of interest on our side of the aisle. But it was not very long before Secretary Mnuchin and the Trump economic team made a full-scale retreat from that principle.

Now the administration has a one-page plan of tax reform bullet points. There is a lot of detail about how the fortunate few get their taxes cut, but not much detail about how relief is going to go to the middle class.

And we all remember when Henry Ford said, "Look, I want to be successful. For me to be successful, working people have to have the money to buy my cars." So it is all about the working class.

And in fact, under the Trump plan, independent analyses said millions of working Americans were in line for a tax increase. Furthermore, in the last few weeks, the Treasury Department has begun to wipe out tax rules designed to crack down on corporate inversions, protect jobs, and close estate tax loopholes. But without a plan waiting in the wings to replace those rules, that means that the Treasury Department risks a new outbreak of the inversion virus—an outbreak that would put more jobs at risk and condone tax avoidance.

Here in the Congress, there are widely circulated pictures of a meeting of a group called the "Big Six"—big blow-up in *The Wall Street Journal*—comprised entirely of Republican Senators, Representatives, and Trump officials. And it says, these folks are going to do the tax overhaul.

Now, Republican members have already telegraphed a plan to transplant the Trumpcare tax breaks for the wealthy into a big, regressive tax cut later this year. And majority leadership in the Senate has said repeatedly in the media that they plan to move tax legislation with the same my-way-or-the-highway approach—we all know that as reconciliation—that has been used, and clearly has not turned out well, on health care.

It is hard to look at that concrete evidence—concrete evidence—and find proof that the majority party wants real Democratic involvement in tax reform. And I would just say to my colleagues, you go back and read those histories of the 1980s, and by this time in 1986, Democrats and Republicans were hip-deep into going back and forth about how you would do bipartisan tax reform.

Now anybody can write a bill that slashes tax rates for the fortunate few and the biggest corporations, and you might even be able to get enough support to get it enacted into law, particularly if you

use a partisan-only approach. I would just say as we launch this, that is not a good way to get the certainty and predictability that is really needed to create good-paying jobs and expand opportunity.

It might be a good way to create tax windfalls for the fortunate few, but it is not a good way to grow our economy and respond to the numbers that we saw just last week that showed that wage growth is flat. The jobs numbers were not bad, but wage growth was flat. And having middle-class people with money to buy cars and get education and childcare and houses, that is how you make an economy.

Mr. Chairman, I will close with this. You and I have talked about this often, and you and your staff know that I have spent hundreds of hours, literally, to produce what are still the only two bipartisan comprehensive Federal tax reform bills since 1986. One was with our former colleague, Senator Gregg, whom Mitch McConnell looked to on economic issues, and most recently I worked with our friend who sat down there, Senator Dan Coats, now at the Office of the DNI.

They gave everybody a chance to get ahead. They were built around progressivity—progressivity and tax reform that puts growth first by putting money into the pockets of wage-earning Americans. It is lasting and bipartisan.

I am interested in hearing from our witnesses who can talk to us about the lessons of the past in terms of finding common ground and moving ahead.

And the last point I just want to make deals with health care. Obviously, there were major developments last night. I hope after it has become clear that the partisan approach, trying to just ram a bill through that raises premiums, hurts those with preexisting conditions, slashes Medicaid—it has now failed twice.

So I would hope, as we start this tax reform discussion this morning, we would say that using a partisan approach for the major issues of our time, health care and tax reform, is a prescription for trouble. It is a prescription for gridlock. It is a prescription that will make it harder to solve the problems that the American people sent us here for.

Now, I will just close, Mr. Chairman, because you have a long history—and we joke a lot about it—going all the way back to Senator Kennedy. So you have a long history of working in a bipartisan way. On this side of the aisle, we would like to bring that kind of focus both to health care and tax reform in the days ahead.

Thank you.

The CHAIRMAN. Well, thank you, Senator.

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

The CHAIRMAN. Today we have the distinct pleasure of welcoming four former Assistant Secretaries for Tax Policy to our committee. I want to thank you all for agreeing to appear here today and for being willing to talk about such an important topic.

First we will hear from Mr. Jonathan Talisman, a founding partner of Capital Tax Partners. Mr. Talisman served as the Assistant Secretary for Tax Policy for the U.S. Treasury Department during the Clinton administration. Previously, Mr. Talisman had also

served at the Treasury as the Deputy Assistant Secretary for Tax Policy and the Tax Legislative Council.

Before joining the Treasury Department, Mr. Talisman served from 1995 to 1997 as the chief Democratic tax counsel of the Senate Finance Committee under Senator Moynihan, and from 1992 to 1995 as legislative counsel to the Joint Committee on Taxation.

Prior to his tenure in government, Mr. Talisman worked in the Washington office of Akin, Gump, Strauss, Hauer, and Feld from 1984 to 1992, where he specialized in transactional tax planning.

Mr. Talisman currently serves on the board of advisors to the Tax Policy Center and was chair of the Formation of Tax Policy Committee, American Bar Association Tax Section. He also currently serves as an adjunct tax professor at Georgetown University Law Center, where he teaches tax policy.

Mr. Talisman holds a bachelor's degree from the University of Virginia and a juris doctorate from the University of Virginia School of Law.

Next up will be Ms. Pamela F. Olson, the U.S. Deputy Tax Leader and Washington National Tax Services leader of PricewaterhouseCoopers. Prior to joining PwC, Ms. Olson led the Washington tax practice at Skadden Arps and served as Assistant Secretary for Tax Policy at the U.S. Department of the Treasury from 2002 to 2004.

Ms. Olson has also previously served as a senior economic advisor to two presidential campaigns and as Federal tax advisor to the National Commission on Economic Growth and Tax Reform. Ms. Olson has also held positions with the Chief Counsel's Office of the IRS as Special Assistant to the Chief Counsel, Attorney Advisor in the Legislation and Regulations Division, and trial attorney in San Diego District Counsel. In 2001 and 2002, Ms. Olson was the first woman to serve as chair of the American Bar Association Section on Taxation.

Ms. Olson received her BA, MBA, and JD from the University of Minnesota.

Third, we will hear from Mr. Eric Solomon, the codirector of the National Tax Department of Ernst and Young in Washington, DC. Mr. Solomon formerly served at the Treasury Department and IRS, holding various roles in the Office of Tax Policy at Treasury from 1999 to 2009 in both the Clinton and George W. Bush administrations.

He was the Assistant Secretary for Tax Policy from 2006 through 2009. At the IRS, he headed the Corporate Tax Division in the Office of Chief Counsel from 1990 to 1995.

Before his government service, he practiced in law firms in New York City and was a partner at Drinker, Biddle, and Reath in Philadelphia.

Mr. Solomon is a member of the Executive Committee of the Tax Section of the New York State Bar Association and has been an officer of the American Bar Association Section of Taxation, and he teaches corporate taxation in the LLM program at Georgetown University.

He is a graduate of Princeton University and the University of Virginia Law School, and received his LLM in taxation from New York University.

Finally, we will hear from Mr. Mark J. Mazur, the Robert C. Pozen director of the Urban Brookings Tax Policy Center.

From 2012 until early this year, Mr. Mazur served as the Assistant Secretary for Tax Policy at the Department of Treasury. Prior to this service, Mr. Mazur served in the Federal Government for 27 years in various positions, including policy economist at the congressional Joint Committee on Taxation, Senior Economist at the President's Council of Economic Advisers, Chief Economist and Senior Policy Advisor and Director of Policy at the U.S. Department of Energy, as Acting Administrator of the Energy Information Administration, Director of Research and Analysis and Statistics at the IRS, and Deputy Assistant Secretary for Tax Analysis in the Office of Tax Policy.

Before entering public service, Mr. Mazur was an assistant professor in Heinz College at Carnegie Mellon University. He has a bachelor's degree from Michigan State University as well as master and doctorate degrees from Stanford University.

Mr. Talisman, please kick us off with your opening remarks, and we will go from there.

STATEMENT OF HON. JONATHAN TALISMAN, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2000–2001, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. TALISMAN. Thank you, Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee. Thank you for inviting me to discuss tax reform once again with my colleagues and friends. I am appearing here on my own behalf.

Several of us appeared on a similar panel 6 years ago at a hearing entitled "How Did We Get Here?" Given the consensus for tax reform, this hearing might be entitled "Why Are We Still Here?" But in all seriousness, significant progress has been made in the interim.

First, the fiscal cliff agreement largely fixed the encroachment of the AMT and prevented it from morphing from a class tax to a mass tax. Similarly, in 2011, we had well over 100 structural extenders, and these were fixed in the PATH Act by permanent extensions or for 5 years. In addition, over the last 5 years, both tax-writing committees have conducted a thorough examination of the principle tax reform options that exist, including numerous hearings, bipartisan working groups, and comprehensive reform bills by committee members.

I believe it is time for Congress to heed the instructions Yoda gave to Luke: "Do. Or do not. There is no 'try.'"

Let me briefly explore some of the remaining impetuses for reform and impediments that remain.

Competitiveness and growth. As has been well-discussed, the United States has the highest statutory corporate tax rate among our major trading partners. Broadening the base and lowering the rate would improve productivity, reduce distortions, and attract foreign direct investment. Also, our worldwide international tax system is out of step with the rest of the world, which generally has adopted some form of territorial system.

This combination often causes U.S. businesses to be at a competitive disadvantage in foreign markets and creates a "lockout" prob-

lem for redeployment of foreign earnings. Other countries are taking significant steps to attract headquarters, IP ownership, and other cross-border investment. We must respond soon to these global tax developments to avoid a detrimental effect to our economy and U.S. receipts in general.

Efficiency. Broadening the corporate tax base could improve the efficiency and neutrality of our tax system. However, we must recognize that many tax expenditures are longtime and desired features of our system embedded in the fabric of our economy. Whether to retain them should be based on whether the purpose is still valid, whether the expenditure is efficient, and what the potential economic and social dislocations would be if it were eliminated.

Also, in seeking offsets, policymakers must be careful to avoid reforms that do more harm than good, such as revenue proposals that limit ordinary and necessary business expenses. As I have written in *Tax Notes,* a case in point is limits imposed on the deductibility of business interest to eliminate the purported debt bias.

This would overstate economic income and act as a negative tax expenditure. A better solution would be Chairman Hatch's proposal for a form of corporate integration.

Fiscal responsibility and long-term deficits. CBO Director Keith Hall has said that to put debt on a sustainable path, lawmakers would have to increase revenues, substantially reduce outlays, or adopt some combination thereof. Obviously, policymakers must keep this in mind in crafting tax reform.

Income inequality and a shrinking middle class. The issue of rising income inequality and the thinning of the middle class is a critical issue that should be addressed as part of tax reform. This is not a partisan issue.

In the campaign, President Trump talked about a hollowed-out middle class and a system rigged against average Americans. Economists warn that it may be slowing overall economic growth. Glenn Hubbard, Senior Economic Advisor in the Bush administration, suggests that the pro-growth agenda may not be sufficient to generate inclusion and mass prosperity.

One positive step would be adoption of legislation proposed by Senators Brown and Bennet to expand the EITC for childless workers and to strengthen the child credit for families with young children.

And finally, *fairness.* The fairness of the tax code is highly subjective, but it will be critical to the success of tax reform that it be perceived by the general public as fair.

Let me turn to the impediments. Obviously, there is a strong consensus in favor of tax reform. Why has it not happened? Well, it is hard.

Health-care reform affects only 17 percent of GDP. Tax reform affects 100 percent of GDP. And while agreement exists that tax reform is needed, there is no clear consensus as to approach.

It will be important to agree on the goals and intended benefits of tax reform. And then the President and policymakers must market those goals to the American public. The success of the 1986 Act was largely attributable to the efforts of President Reagan and Chairman Rostenkowski, initially, in selling it to the American public.

Rostenkowski famously asked people to "write Rosty" to stand up for fairness and lower taxes. He received more than 75,000 letters and one package with a wooden two-by-four with instructions to use it on any interfering lobbyists.

Engaging and educating the public is essential to build support and minimize blowback. Bipartisanship is also important to develop major legislation that does not divide the American public and is lasting. While a partisan approach to tax reform seems easier to accomplish, the truth is it creates numerous impediments that will be difficult to overcome. For example, use of budget reconciliation can be a "Faustian bargain," invoking the Byrd rule and other procedural protections.

Finally, while most business leaders are anxious for tax reform, they are not yet unified in their vision. For example, a dispute still exists regarding the form of base erosion in a shift to a territorial system. The business community must find a way to come together.

I would like to close with two final thoughts. First, do not worry about solving all perceived problems at once. Incremental progress will be a significant accomplishment. Debates over more fundamental reform should not delay or preclude meaningful reforms to improve the code.

Second, be careful not to worsen or inhibit our ability to address our impending long-term problems. Hopefully if this happens again in 6 years, I will be retired.

I stand ready to assist the committee in any way that I can. And I would be happy to answer any questions that you might have.

The CHAIRMAN. Well, thank you so much.

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

The CHAIRMAN. Ms. Olson, we will take your testimony.

STATEMENT OF HON. PAMELA F. OLSON, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2002–2004, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Ms. OLSON. Thank you.

Good morning, Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee. I appreciate the opportunity to appear this morning. I am tempted to say "what he said," and leave it at that.

I am here today on my own behalf and not on the behalf of PwC or any client. The views I express are my own.

The late Treasury Secretary William Simon once observed that the Nation should have a tax system that looks like someone designed it on purpose. Unfortunately, the tax system we have leaves much to be desired. We have already heard a lot about that this morning.

Tax reform is just one of a number of critical issues facing the country, but reforming the tax system is foundational to fixing many of the problems we face. Tax reform would set the stage for stronger economic growth, more jobs, higher wages, and a more broadly shared prosperity.

It is critical that the committee's effort at tax reform succeed. No one doubts that tax reform is hard—so hard that it has its own

hashtag—#TRIH. A better indicator is that it has been 31 years since Congress last enacted comprehensive tax reform.

Before highlighting a few points from my written statement, which is focused on business tax reform, I want to note that there is a need to make the tax code simpler for individuals and families seeking to save for education and retirement, and less burdensome for entrepreneurs seeking to start and grow their own businesses. Families and small businesses, in particular, spend far too much time on paperwork and record-keeping to comply with the intricacies of the Internal Revenue Code.

There will always be concerns about whether benefits and special provisions have been targeted appropriately to the intended recipients. These concerns inevitably lead to intricate details that complicate compliance. Moreover, they often lead to drawing lines that may be entirely rational and justifiable in the abstract, but that in the real world lead to differential treatment that adversely affects individuals' perception of whether the tax system is fair.

To the maximum extent possible, Congress should resist the urge to write narrowly targeted rules in favor of broadly applicable provisions.

With respect to business tax reform, it is important to keep in mind—as I think we have already heard this morning—that opportunities for investment are increasingly global, and the competition for investment is fierce. Every decision to invest elsewhere makes more logical the next decision to invest elsewhere, as the locus of activity shifts to other locations.

The U.S. market remains globally attractive, but that is despite our tax system which impedes investment, not because of it. By failing to address the features of our tax system that discourage investment here, we will leave investments on the sideline. Moreover, if we broaden the base in ways that make U.S. investment less rewarding, we will lose investments to other jurisdictions.

With that in mind, Congress should aim for comprehensive tax reform as opposed to temporary tax cuts, which will require careful consideration of competing interests and of the country's pressing fiscal concerns. Congress should aim for reform that is sustainable. To be sustainable, tax reform must produce sufficient revenue to cover the cost of what Congress agrees to spend. And it must result in a system that attracts and retains the business investment needed for the economy to grow.

A system that leaves an unlevel playing field that continues to discourage capital investment and business formation in this country is an inherently unsustainable system. The elements of a well-designed tax system include a tax rate competitive with the rest of the world and an international tax system that creates a level playing field and eliminates barriers to domestic reinvestment.

With respect to revenue neutrality, Congress should focus on base-broadening measures that close loopholes or eliminate provisions that distort investment decisions, as distinguished from measures that would have the effect of increasing the cost of capital and discouraging investment in the United States.

With respect to international, the need to protect our tax base is self-evident, however all anti-base erosion measures are not created equal, and the unintended consequences of anti-base erosion rules

could be significant. The best anti-base erosion measure is a well-designed system starting with a low rate that attracts investment and reduces the incentive to avoid the tax system.

The world is changing rapidly. I do not think we can any longer afford to look at tax reform as a once-in-a-generation exercise. Once reformed, the United States must maintain a tax code that promotes economic growth and improves the well-being of all Americans, which will require each succeeding Congress to examine the tax system and build on prior reforms.

So, to quote Dr. Seuss, "The time has come. The time is now."

Thank you again for the opportunity to testify. I would be pleased to answer questions the members may have.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. Mr. Solomon?

STATEMENT OF HON. ERIC SOLOMON, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2006–2009, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. SOLOMON. Mr. Chairman, Senator Wyden, and distinguished members of the committee, thank you for the opportunity to testify today on tax reform. I am here today speaking on my own behalf.

For many years, policymakers have expressed a desire to reform the Internal Revenue Code. Much has changed since the last major overhaul in the Tax Reform Act of 1986. All of us recognize that updating the code is a necessity. We hope we are at a climax in this effort, and that in the coming months we will see the enactment of significant reform.

In March 2011, I had the privilege of testifying before this committee about tax reform. As I stated in my testimony then, the primary purpose of the Federal tax system is to collect the revenues needed to fund the government.

We would all agree that the goals of an optimal tax system would include promoting economic growth, minimizing distortions, and supporting the competitive position of American businesses around the globe. In addition, our tax system should be as simple as possible for all Americans. It should also be fair and stable. It should also be administrable for individual and business taxpayers as well as for the Internal Revenue Service. Our current tax system is suboptimal in achieving these goals.

We live in a constantly changing world. Economic, social, and political developments, including accelerating advancements in technology, are changing our Nation and its role in world affairs and the global economy.

As the global economy evolves, we need to re-evaluate our tax laws to ensure they are responsive to current and anticipated domestic and global conditions. We must also recognize that our tax system does not operate in a vacuum. It is one of many tax systems around the world. And as other countries revise their tax systems, we must respond as necessary to ensure that our tax system is in the best possible position to facilitate outbound and inbound investment and maximize the welfare of the American people.

Numerous tax bills have been enacted since 1986. The Internal Revenue Code is a patchwork of provisions serving a wide variety

of purposes. As the code grows, and the regulatory and administrative guidance interpreting and implementing the code also grows, our enormously complex tax system becomes even harder for taxpayers to understand and for the IRS to administer.

There is a pressing need for tax reform. We need tax reform to promote economic growth. We need reform to reduce complexity. We need to fix a system that taxes some taxpayers at high effective rates but others at much lower effective rates because of special provisions. We need reform to address the incentives to use debt rather than equity.

We also need tax reform to address our inadequate international tax system, which creates a lockout effect that encourages corporate taxpayers to keep their foreign earnings offshore because those earnings will not be subject to tax until they are repatriated. This repatriation tax does not exist in other countries.

Moreover, we need tax reform to reduce the incentive for American businesses to move their activities offshore.

The debate about tax reform has been ongoing for over a decade. Extensive groundwork has been laid by the work of policymakers such as yourselves, academics, taxpayers, and practitioners. It is now essential to take the next step and enact reform that, among other things, reduces tax rates, eliminates various preferences, simplifies the law, modernizes the international tax system, and helps American workers and families.

If possible, these reforms should be permanent. All of this should be achieved in a fiscally responsible manner. Everyone is aware of the long-term fiscal challenges our Nation faces as spending, especially mandatory spending, continues to increase. We need to reform our tax system in a manner that does not disadvantage us in addressing our long-term budget imbalances.

There are a number of important issues that need to be addressed in crafting a bill. These issues are described in my written testimony. They include, for example, whether reform should be revenue-neutral, how much tax rates can be reduced, what deductions, credits, and other provisions should be eliminated, how cost recovery should be handled, whether interest deductions should be limited, whether border adjustments should be adopted, what base erosion rules are needed, and how to deal with pass-through entities.

The list of issues that must be addressed may appear to be daunting. Nevertheless, it is important to enact legislation as quickly as possible that will end uncertainty and benefit American businesses, workers, and families.

There will necessarily be compromises along the way, but the most important objective is to enact tax reform that moves the tax law in the proper direction. There is a window of opportunity now, and it is important to act before that window shuts.

In March 2011, I closed my testimony before this committee by referring to the story in Greek mythology about the fifth labor of Hercules. His task was to clean the Augean stables, which had not been cleaned in 30 years. More than 30 years have passed since the Tax Reform Act of 1986. We need to complete the Herculean task of reforming our Internal Revenue Code.

Thank you for the opportunity to testify today.

The CHAIRMAN. Well, thank you very much.

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

The CHAIRMAN. We will now turn to Mr. Mazur.

STATEMENT OF HON. MARK J. MAZUR, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2012–2017, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MAZUR. Chairman Hatch, Ranking Member Wyden, members of the committee, thank you for inviting me here to testify today and to discuss issues surrounding broad-based tax reform.

The views that I express are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

What I want to do today is put some guardrails around the tax reform effort, guardrails that are necessary to have a serious conversation about making the tax system more efficient, more effective, fairer, and simpler.

The first of the guardrails is ensuring that the Federal tax system generates adequate revenue to pay for the goods and services that Americans demand from their Federal Government.

Today the Federal tax system raises around $3.3 trillion a year. That is about 17 or 18 percent of gross domestic product. And this still leaves us with a Federal budget deficit of about $500 billion per year. And given demographic trends, expenditures are going to increase with the growing retirements of baby boomers.

So if we are serious about getting our fiscal house in order, realistically we need to put higher revenues on the agenda for the medium- and longer-term. If you recall, the last time that we balanced the budget, fiscal years 1998 until 2001, revenues were in the 19- to 20-percent of GDP range.

A second guardrail is fairness of the tax system. Economists have a term called "horizontal equity." That means similarly situated people are treated similarly. Generally, this means a source of income should not determine the tax rate unless there is a compelling reason to do so.

So a construction worker should be taxed the same as the owner of a construction firm if their incomes are about the same. A teacher should be taxed about the same as a farmer with similar incomes, and a lawyer at a partnership—law firm—should be taxed the same as a legislator with similar incomes. To violate this notion of fairness brings into question the overall fairness of the tax system.

A third guardrail is another version of fairness, what economists call "vertical equity." That simply means that those with the greatest ability to pay taxes should bear a proportionally larger financial share of the responsibilities of government. This concept is associated with a progressive tax system where the average effective tax rate increases with income.

The overall Federal tax system today is mildly progressive, and the individual income tax is fairly progressive. This relationship holds through most of the income distribution, though the very, very top of the income distribution—say the top 0.01 percent—they actually pay lower taxes than those with slightly lower incomes.

A fourth guardrail is simplicity. There is a sense among taxpayers that the tax code is too complex for ordinary Americans to understand. And this sense of complexity is evidenced by the robust tax preparation and software industries.

A lot of the existing complexity just reflects the increasingly complex world in which we live. Individuals and businesses can enter into almost a limitless number of transactions. These possibilities reflect economic and social complexity, globalization, and longstanding efforts at financial engineering.

However, we all have been complicit in the growing complexity. Over the past 3 decades, increasing amounts of social policy have been driven through the tax code.

Every one of these provisions might be an efficient way to deliver benefits to particular taxpayers, but every one carries with it eligibility rules and benefit calculations, and these can overwhelm taxpayers with their complexity.

So with these guardrails in mind, we can think about undertaking tax reform. Previous reform efforts have taught us three lessons. (1) Tax reform is technically difficult. There are a lot of moving pieces that need to be looked at together. (2) Tax reform is even more difficult politically. When undertaking true reform—kind of the broaden-the-base, lower-the-rate variety—key constituencies often break along geographic, or demographic, or industry lines, not partisan lines.

And this leads to a third lesson, which is that bipartisan tax reform may prove to be durable reform. And this committee's long tradition of bipartisan legislating bodes well for playing a leading role in developing a durable consensus on tax reform.

There are some targets of opportunity for tax reform. Perhaps the largest is business tax reform. My colleagues on the panel have talked a lot about this.

If we look back at the Camp plan or the Obama administration plan for business tax reform, there is a lot of overlap there and a lot of good ideas on what you could do going forward on business tax reform. And there are a lot of smaller opportunities where tax reform progress can be made. These include tax incentives for education, which could be comprehensively overhauled and simplified in a revenue-neutral way that would make them more effective.

There are also changes to income inclusion rules for debt forgiveness associated with student loan debt that could be addressed. Every one of you has students in your States who have been victimized by unscrupulous schools, and this really cries out for an equitable solution.

And finally, increased access to cash accounting is another opportunity for low-hanging fruit—on the business side of the ledger, you can take some steps to improve the tax system.

So to sum up, the country would surely benefit from tax reform. Tax reform is politically hard, but the benefits of doing it can be substantial. Tax reform should not make our medium- and long-run fiscal situation worse. And there are both big and small opportunities for undertaking bipartisan reform.

Thank you for your attention. I would be happy to answer questions you may have.

Senator WYDEN [presiding]. Thank you all.

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

Senator WYDEN. This has been an excellent panel, and we appreciate your walking us through some of the history that is so important.

I am going to start with a question that I think goes right to the heart of the debate. I would just like to hear your thoughts and get you on record.

The tax code is insanely complicated. Yet, determining the centerpiece of bipartisan tax reform should not be. The centerpiece needs to be creating opportunities for working families in America to get ahead, especially policies that help increase their take-home pay so that they can make those kinds of purchases that drive an economy where the consumer is responsible for 70 percent of the activity.

I want to just zip down the row—starting with you, Mr. Mazer—to get your thoughts on the importance of focusing on the middle class and their opportunities to get ahead as a centerpiece.

Mr. MAZUR. Thank you, Senator Wyden.

Focusing on the middle class is really what you want to do. You want to make sure that folks who are in the middle of the income distribution feel that the tax system is fair and that they are getting fair amounts of return on their taxes paid.

A larger issue, though, I think, is ensuring that there are adequate jobs and wage growth in the economy. And that may——

Senator WYDEN. Why? That is why I linked the two—wage growth, more growth—and the middle class driving it.

Mr. MAZUR. If you want to look at that, probably the area of business tax reform is the one where you could make the best progress.

Senator WYDEN. Okay.

Mr. Solomon?

Mr. SOLOMON. Tax reform needs to help all Americans, including the middle class. As Mr. Mazur has pointed out, economic growth from a better system will create jobs and opportunities. Also, due to the fact that there will be fewer distortions, reform will make economic decisions more neutral and will help the economy and all Americans.

Also, simplification will be important to reduce compliance burdens. Simplification will help Americans understand the benefits that are available to them through the tax code. For example, all the various education benefits are hard to understand, and simplifying them, perhaps combining them, would be extremely useful.

One other point is, we have a voluntary compliance system, and having a fairer, more understandable system will promote confidence in the fairness of our system.

Senator WYDEN. Okay.

Ms. Olson, talk about the importance of the middle class as the centerpiece of tax reform.

Ms. OLSON. Yes. I think that tax reform is all about creating a stronger economy, and a stronger economy is going to generate more jobs, it is going to generate rising wages, and it is going to generate a more broadly shared prosperity.

So, if we can get the foundations right for tax reform to increase investment, that is going to get us where we want to go. It is going to get us more jobs, higher wages.

Senator WYDEN. Good.

Mr. Talisman?

Mr. TALISMAN. Senator Wyden, I agree with the notion that tax reform should be judged by how it increases our standard of living for the middle class and others. I think that, obviously, corporate reform must also be judged by whether it increases job and wage growth. And I think—as I testified in my written testimony—that we also have to make sure that we increase opportunity for people at the low end and in the middle at the outset, because those efforts will save us money in the long run.

Senator WYDEN. I think that last point is important. One of the areas I have been very interested in and I know Bob Casey and Sherrod Brown have been very interested in is, we doubled the Earned Income Tax Credit, and we were able to get Republicans in support of that. So that is a good point.

A question for you, Mr. Talisman—maybe we will put you into this as well, Mr. Mazur. The Trump plan proposes a special 15-percent tax rate for partnerships and limited liability corporations. I have a lot of concern about this.

The 15-percent special rate could create a massive new tax shelter that would allow the wealthy to funnel their money through sham partnerships and limited liability corporations. Now the administration's nominee Mr. Kautter—and we will be hearing from him—has testified that the so-called rate parity could be accomplished quite simply by taking the amount of a taxpayer's Schedule C income and Schedule E income and multiplying that by 15 percent. And somehow this is going to be some hocus-pocus.

Now, what do you think of this? Is this going to create a big loophole?

Mr. TALISMAN. Well, it would be good for me, because we are in pass-through form. [Laughter.] But seriously, I think it could be costly and prone to abuse. I think you obviously do not want to allow taxpayers to convert service income into this special pass-through rate income. And so it will be necessary to separate service income from capital income.

We have in the past provided, through our regulations, various ways of doing that. Those should be looked at. They are in the payroll tax area as well as in the passive loss area.

And I think another thing that could be looked at is maybe providing some sort of payroll tax credit to pass-throughs—rather than looking at a rate reduction—which would encourage job growth.

Senator WYDEN. Very good.

I think, looking at the order of our colleagues, it goes next to Senator Casey and then to Senator Isakson in order of appearance. Senator Casey?

Senator CASEY. Thank you very much.

I want to start by saying that each of you has given the country substantial public service in the positions you held in the United States Government, and you are continuing that service with testimony like this. It is critically important that, as we take the time to consider ideas about how to reform the code and also undertake

an effort to put in place a good process, having your experience brought to bear on that is very helpful. So thanks for that continuing service.

I guess I will start with Mr. Talisman, and maybe I will jump over to Mr. Mazur as well. As you know, the White House put forth a proposal, a brief—I guess it was a one-page proposal, an outline. And one of the features of that was to repeal, except for three, all deductions. I guess they exempted charitable, home mortgage interest, and retirement. So I guess most would consider that a repeal of above-the-line deductions.

I want to ask—maybe I will ask the whole panel. That might be easier, just to go from left to right, starting with you, Mr. Talisman. What do you believe the impact would be if you enacted a tax reform bill that repeals above-the-line deductions and deductions like the State and local tax deduction?

Mr. TALISMAN. Senator Casey, the State and local tax deduction was put in place and kept in place because of notions of federalism, the ability to pay and also to protect against double taxation. We actually provide a Federal tax credit. Nobody views that as an expenditure, and it also provides double taxation relief.

Eliminating the State and local tax deduction could be viewed as an unfunded mandate, in my opinion, because it will make it more difficult for States to raise revenue. So I think that we also have to look at the collateral consequences of getting rid of the State and local tax deduction. It also has an effect, indirectly, on the charitable deduction as well as other itemized deductions.

Senator CASEY. Ms. Olson?

Ms. OLSON. I think this is proof that the effort to simplify the Internal Revenue Code is incredibly difficult. I do think that all of the itemized deductions should be on the table for consideration.

One of the things that the Treasury Department looked at when I was the Assistant Secretary was a plan to get rid of the alternative minimum tax by, among other things, putting both a floor and a ceiling on State and local tax deductions. It would have a progressive effect on the income tax because the deductions skew towards the upper end of the income spectrum.

So I think it is a complicated question. I think there are a lot of things to look at in connection with it, but in addition to the points that Jon made, I think it is important to look at the positive aspects of limiting it in some fashion as well.

Senator CASEY. Thank you.

Mr. SOLOMON. Senator Casey, I would like to approach the question from a slightly different direction. One of the objectives of tax reform is to lower rates on individuals and broaden the base.

So all of this is part of a larger fabric, and in determining which deductions that one might eliminate, one can figure out how much one can lower the rates. The lower the rate, the better. So it would be necessary to put all of this together and go through it on a deduction-by-deduction basis and decide whether or not the benefit that each brings is worth the additional complexity that it adds to the code.

So unfortunately, as Pam points out, it is a very difficult process that will require both determining how much we can lower the rates and also looking at the value of each of the particular deduc-

tions. For example, as you know, the purpose of the home mortgage interest deduction is to promote housing, and the purpose of the charitable deduction is to promote charitable contributions.

But I think it would require that an analysis be done that combines both of those elements.

Senator CASEY. Thank you.

Mr. Mazur?

Mr. MAZUR. Senator Casey, as you point out, the Trump administration tax plan was basically a one-page outline. The Tax Policy Center did an analysis of what we know and do not know about the Trump tax plan.

And basically, the takeaways of that are (1) it cuts taxes a lot—by trillions of dollars over the budget window; (2) the benefits are tilted toward high-income individuals and, even though some of the deductions, like the State and local deduction, are taken out, the benefits of those are tilted more to the middle, not the very tiptop of the income distribution; and (3) a significant fraction of families would actually see a tax increase under that plan, namely those who had large deductions that were taken away and were not compensated for by rates that lowered enough to reduce their taxes overall.

But we have done some analysis on that. We look forward to seeing some more detail from the administration.

Senator CASEY. Thanks very much.

Senator CANTWELL [presiding]. Senator Isakson?

Senator ISAKSON. Thank you, Senator Cantwell.

Let me follow up on what Ranking Member Wyden asked. He asked about what would be most—if I remember correctly, and somebody please correct me if I heard this wrong—what would be most beneficial and helpful to the middle class. Is that not correct?

[No response.]

Senator ISAKSON. I think every one of you in whole or in part, beginning with Mr. Mazur, talked about the corporate tax or the business tax. That tax rate that a business pays is going to have the greatest effect on the middle class, because that is the money with which they employ people, expand the business, et cetera.

Ironically, I was at a dinner last night with two of the major corporations in the United States. They are competitors, both in the same business. It was not a private meeting. It was not a violation of the antitrust laws, I can assure you of that. We were learning about them, what they thought about tax reform if it comes before the Senate.

Both of them, in the course of the conversation, said the effective tax rate they paid in the United States was 34 percent. They are both C corps. They have one major foreign-based competitor whose effective tax rate is 19 percent.

You are getting to the point where the taxes, the differential on investment that competitors would make one to another in their companies, in the end is going to determine where that money is going to go as far as the middle class is concerned. Are we at the point where we really have to take a look at our competitiveness as a Nation and look specifically at the tax code to make that differential more fair?

Mr. Mazur?

Mr. MAZUR. Senator Isakson, if you look at the United States corporate tax system, we have just about the highest tax rate in the world. We have an effective tax rate that is around the middle of our trading partners. That indicates that it should be possible to broaden the base and lower the rate and get the rate down to around the middle of our trading partners.

We are never going to have the lowest tax rate in the world. I think you do not want to get into a race to the bottom on tax rates, but with some serious thought about doing tax reform, we can lower the corporate tax rate and get it down to where it is within shouting distance of many of our trading partners.

Senator ISAKSON. That is an excellent point, because one of the points that came up last night is, we are a better place to do business because of the transportation, because of safety, because of security, because of environment, and all of those things. But there is a point at which you run out of those benefits when you are talking about so much of your income being paid in taxation. So I appreciate that point. It is an excellent one.

Let me go to consumption tax versus income tax. I come from the State where the author of the book called "The Fair Tax" comes from. He is on the radio all the time. If I do not end up asking some question about consumption tax when we have a hearing like this, I get chastised at home.

So just to go down the row, how many of you are familiar with the fair tax proposal, which is to convert from an income tax to a sales tax? And what is your general thought, or do you have any thought about it at all?

Mr. Mazur, we will start with you.

Mr. MAZUR. I guess my basic thought about our tax system is that we have a portfolio of taxes. Some are based on income, some based on consumption. We have payroll taxes—so, a portfolio of taxes.

Having a consumption tax would make some sense. Almost every one of our trading partners has a value-added tax. So you can imagine having that as part of a portfolio of taxes.

A shift from an income tax to a consumption tax—that is a huge change, and probably beyond the tolerance of the American public to adjust to the change. But having a consumption tax as part of the portfolio of taxes, that is what every other country does.

Senator ISAKSON. Okay. Does anybody else have a comment? Yes, ma'am?

Ms. OLSON. I included support for consumption tax as part of a portfolio in my written statement. I think the approach that Professor Michael Graetz has been advocating for a number of years, as well as a bill introduced by Senator Cardin, would take us a long way in that direction and would match our system with the tax systems of other countries, which is how those other countries have managed to significantly reduce their corporate taxes and create a system that is more conducive to investment.

Senator ISAKSON. I think the most important thing, if we make a change like that, is how you convert the taxpayer from the old system to the new one. One of the big problems we had in 1986 was passive loss. We went back and clawed back and changed the treatment of passive loss and changed the treatment of invest-

ments and changed the balance sheets of a lot of corporations, particularly, construction corporations. So transition is critical.

Yes, sir? Were you going to——

Mr. SOLOMON. Just to add, even our income tax is in part consumption tax. It is not a pure income tax. There are many consumption tax aspects of our current income tax; for example, retirement savings are not subject to tax.

So even what we consider an income tax is really a hybrid. If we were to move to a consumption tax, then transition is a very important issue.

I also think that dealing with income distribution would be a very important aspect, to understand how it affects income distribution as compared to our current system. Also if you switch completely to a consumption tax, you would also have to think about what rate it would be imposed at and what effect that might have.

Senator ISAKSON [presiding]. Thank you all for your testimony. I guess Senator Warner is next.

Senator WARNER. Thank you, Mr. Chairman.

I guess it is interesting. I appreciate very much the panel being here, and this is one of the first hearings we are having on tax reform. It is a little disturbing. It is down to Johnny Isakson, Mark Warner, and Bill Cassidy as the only members who are still here at this point.

Senator ISAKSON. If they will leave it to us, we will fix it up good.

Senator WARNER. I thought it was interesting when we talked about this issue, at least the first three panelists quoted "Star Wars," Dr. Seuss, and Greek mythology. I am not sure what that all meant, but it did say maybe how challenging this is.

I want to make a bit of a comment, then ask a question. Here is my worry. And I agree very strongly with Mr. Mazur that I want to do tax reform. I want to bring our corporate rates much lower. I believe very strongly we need to do repatriation and bring those earnings that are offshore, back.

But as somebody who spent a couple of years trying to put together the Simpson-Bowles Plan, I really worry whether we are going to ever have the wherewithal to really make the trade-offs you need to make in terms of broadening the base to really lower the rate.

Six or 7 years ago, when this was the vogue, the bid and the ask, I think, on the corporate rate was—you know, the Democrats were more like 28 percent; the Republicans more 25. But because the world has not stayed static, I think we have seen many of our industrial competitors lower their corporate rates down closer to 20 percent, and at least aspirationally, the administration looks at a rate that is closer to 15.

My memory serves, and correct me if I am wrong, that the rule of thumb is, for every point that you lower the corporate rates, you are talking basically $100 billion a point. So it is fairly straight math. If you want to bring it down to 25, you have to raise an additional trillion dollars. If you want to bring it down to 15, you have to raise $2 trillion.

One of the things I do not think, sometimes, my colleagues realize—this is where we actually, I think, have to at least get common

facts—is that if you add up all of our State, Federal, and local taxes combined, America actually ranks as one of the lowest-taxed industrial nations in the world.

The data I have amongst OECD nations shows that America is at 31st out of 34 nations. So, you start with nominally the highest tax rate. When you actually look at collections, we are 31 out of 34.

What I worry about—and this goes to where Senator Isakson was at—all of these nations that a lot of my friends and businesses like to refer to that have business or corporate taxes in the low teens, they all still raise dramatically more revenue than we do. We are at about 24.5 percent of GDP.

I actually think it is unique. I hear a lot of people refer to Germany and their great apprenticeship programs and what have you. They raise close to 35 to 36 percent of their GDP.

Do you think realistically, with so many built-in biases that we have on our tax expenditures—every business is for tax reform until it comes to their tax expenditures—that we can ever get to a rate that would keep us competitive—and let us say for argument's sake that is the low 20s on the corporate side—by actually broadening the base and lowering the rate? Or will we not have to look at what Senator Isakson said, look at a VAT, look at a carbon tax, look at some other broad-based revenue raiser that will allow us to really bring down rates to a competitive level? And I would argue, hopefully, on a permanent basis. I have no interest in another short-term tax holiday without some broad-based new revenue source.

We can take it from Mr. Mazur on down, or we can start at the other end and go up the list.

Mr. MAZUR. I will just jump in quickly.

So first, on your $100 billion per point, it is true for the first point, but each point gets progressively more expensive as the base gets broader. So it is even more than $2 trillion. So the problem is a little bit harder than you think.

Senator WARNER. And that is just on C rates. That does not even talk about pass-throughs.

Mr. MAZUR. Exactly. And then the second point—I think Mr. Isakson hit on this—is that if you want to look at other countries with a low corporate rate, you need another revenue source. It could be a value-added tax like other countries have, or it could be something else. But, you cannot just broaden the base and lower——

Senator WARNER. I just do not think we are ever going to get to broadening the base, because it gets to extremes, but correct me if I am wrong, gentlemen and ladies, please.

Mr. SOLOMON. I would just add, though, I think it is important to take the steps as far as we can to get the rate down as much as possible. This goes back to my answer to the previous question, which is, how can we push the rate down? If we really want to push the rate down, we really have to take on a lot of the tax expenditures.

Senator WARNER. Could we end up saying, all right, let us try as hard as we can on broadening the base and then, if we still have a delta that says we want to get to 20, you could take whatever that delta is and you could put in some form of a consumption tax?

Mr. SOLOMON. Then you have to make the very hard decision of whether or not you want to move to a consumption tax. But I think during this process at the present time, if you really want to push the rate down, you really are going to have to give very hard thought what tax expenditures to eliminate.

Senator WARNER. I doubt——

Mr. SOLOMON. And then the question is, how far can you get the rate down?

Senator WARNER. I doubt if we could even get to 25 on—but please, the last two comments.

Ms. OLSON. No. I agree. I think it will be very difficult to eliminate enough tax expenditures to bring the rate down as far as we need to bring it down in order to be competitive. I certainly agree, we are a low-tax country relative to the rest of the world in terms of overall taxes as a share of GDP, but there are differences in the portfolio of taxes that other countries look to, as shown by a chart in my written statement. And what they do to make up the difference that allows them to have a much more attractive corporate rate is, they have a value-added tax as part of their portfolio.

So do as much as we can, as Mr. Solomon says, but then I think at some point we are going to have to come back, in any event, to look at another tax to add to the list of taxes in order to better align our tax system with the tax system of every other developed country.

Senator WARNER. And those value-added taxes actually can deal—a little bit—with border adjustments.

Mr. Talisman? I know I have taken more than my time.

Mr. TALISMAN. Senator, I will take this in a slightly different direction, because they have said everything I would have said, but this goes to why both bipartisanship and marketing to the American public are important. The only way this gets done is for these difficult issues to actually get sold to the American public, that this is going to raise their standard of living.

So anything you do that is basically going to bring down the corporate rate, if you are going to raise taxes on them through a consumption tax or through tax expenditures, that has to be sold as something that is going to be good for them in the long run.

Senator WARNER. And bipartisanship is not reconciliation.

Senator WYDEN [presiding]. We are going to have to move on, and I share Senator Warner's view.

Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman.

Thank you all for your testimony. You know, the President's tax proposal and the House Republican Blueprint called for the elimination of the State and local tax deduction, which would hike up taxes on thousands of New Jerseyans and millions of Americans across the country. The purpose of the deduction is to save families from double taxation by the State and Federal Governments.

Nevertheless, the Trump administration has advocated for its repeal, arguing that the Federal Government should not be subsidizing the tax and spending policies of individual States. Now, I find it hard to understand. And I want to ask Mr. Talisman—I think you had a little bit of a dialogue on this before. Do you believe that it is fair to force individuals and families to face double

taxation while large, multinational corporations are able to avoid such treatment?

Mr. TALISMAN. Well, as I said before, I think that the State and local tax deduction is about double taxation, as well as about ability to pay and notions of federalism. I think that the foreign tax credit is about double taxation as well. It is not listed as a tax expenditure. The State and local tax deduction is.

I think if we eliminate the State and local tax deduction, we have to be worried about some collateral consequences. Obviously, our State governments—we are putting more pressure on them to fund infrastructure and education, and those issues, obviously, would suffer if we were to remove the State and local tax deduction.

So I think it actually could be treated as an unfunded mandate, except that it is not on the spending side. It is on the tax side. So, yes, Senator, I am concerned about it and appreciate the question.

Senator MENENDEZ. If one believes that the State and local tax deduction subsidizes "progressive States," it seems to follow that the foreign tax credit subsidizes European socialism with American tax dollars. I do not think that is a far stretch. So I do not know that if we get to our logical conclusion of the arguments that are being presented that we would not be adverse to the idea that foreign corporations get the deduction, and they are getting it, in essence, for activities abroad that ultimately, I think, some of my Republican friends would find far more objectionable than what State and local municipalities are doing.

Let me ask you this. Do you believe that the President should sign a tax reform bill that raises taxes on almost a quarter of all middle-class families? And I would open that to anybody.

Mr. MAZUR. Senator Menendez, I think if that was all that it did, then probably no. But you have to look at the totality of what the entire bill does.

Senator MENENDEZ. Well, in my focus on this committee, part of what I want to do is help middle-class families afford a home, an education, and retirement. While on the campaign trail, the President promised to cut taxes on the middle class. What we see under his plan, at least the schematic that we have, is that the top 1 percent of millionaires and billionaires would receive nearly half of all the tax cuts, getting an average of $175,000 back, while almost a quarter of middle-class families would actually see a tax increase.

I do not know that that is tax equity at the end of the day. I do not know how you help middle-class families in that context.

Let me ask you this: is it fair to say that doing tax reform under regular order is more preferable than reconciliation, because of all the policy restrictions that come with reconciliation? Anyone who wants to answer that question, can you elaborate on the weakness of doing tax reform through reconciliation?

Mr. TALISMAN. Well, I think reconciliation—first, you need a budget resolution which, obviously, is somewhat difficult to get, as we saw with health-care reform. Secondly, once you have a budget resolution in place, the margins are narrowed and any dispute could cause the bill to fail. And finally, and most importantly, I think—going to your question, in my testimony I called it a Faustian bargain a little bit, because you bring in the Byrd rule and

other procedural protections in reconciliation that could cause you to then have to engage in gimmickry to avoid them.

Therefore, we sunsetted the 2001 and 2003 tax cuts because of the Byrd rule. And that is an example. And we would have to do things to avoid that in the context of something that was run through reconciliation.

Senator MENENDEZ. And what I have heard consistently from corporate leaders across the country in the last 2 years is, give me predictability and certainty. I do not know that reconciliation does that.

One final question, Mr. Chairman.

The administration has advocated changing the way the cost of tax legislation is calculated or scored for the purposes of analyzing its impact on the budget. But as I think all of you note, different so-called "dynamic scoring models" produce a wide range of results depending on what the assumptions are.

The Joint Committee on Taxation is a nonpartisan, highly respected institution that provides the members of Congress and the general public with objective analysis regarding the cost of tax legislation. Do you agree that Congress and the administration should continue to use and respect the nonpartisan Joint Committee on Taxation as the ultimate arbiter on the cost and impact of tax reform legislation?

Mr. Mazur?

Mr. MAZUR. Senator Menendez, as a Joint Tax alum, of course, I would say that. But I think even as a taxpayer, that is the right thing to do, to look at the professional staff of the Joint Tax Committee and look at their expertise as a way to help Congress get to a rational decision.

Senator MENENDEZ. Does anyone disagree with that?

[No audible response.]

Senator MENENDEZ. You are shaking your heads. So for the record, I will say that no one disagrees and everyone agrees.

Thank you, Mr. Chairman.

Senator WYDEN. Thank you, Senator Menendez.

Senator Thune is next.

Senator THUNE. Thank you, Mr. Chairman.

And I want to thank all of you for appearing here today. We have, collectively here today, witnesses who have served in the last three administrations, and that is a particularly valuable asset to this committee as we continue working to reform the tax code.

As many of you have noted, today's tax code is overly complicated and excessively burdensome. And it has not kept pace with the dramatic changes that we have seen in our economy over the past 20 years, making it a major drag on the economy. So I am hopeful that we can change the code in a way that fosters greater economic growth and that benefits all Americans.

I want to come back to the pass-through rate issue for just a moment. The administration's tax reform framework and the House Blueprint both propose a separate tax rate for pass-through businesses like partnerships, LLCs, S corps, and also sole proprietorships.

This is an area that we have been exploring in particular detail. At first blush, it sounds simple. Just tax the income earned by a

pass-through business at a separate rate, which some have proposed be tied to the corporate tax rate.

But, as we dig deeper, there are a number of challenging questions that arise. For example, how do we account for pass-through owners who are also actively engaged in the business and treat them similarly to an owner of a C corporation who is also an employee of that company?

Should the pass-through tax rate for active owners be based on the return on the capital that they invest in the business or compensation that they pay themselves, recognizing that only S corps can pay an owner-employee wages? If so, how should industry and geographic differences be taken into account? How do we create an equitable system that treats passive owners, pure capital investors, of pass-throughs and C corporations similarly?

And finally, how can a pass-through rate take these factors into account in a way that will be administrable for the business owner and the IRS? So these are just a few of the issues that arise as we explore the proposed separate rates. Some have offered thoughtful approaches that begin to address these issues, like the Bipartisan Policy Center's paper, "Reforming the Taxation of Pass-Through Businesses." I ask unanimous consent to insert a copy of this into the record.

[The paper appears in the appendix beginning on p. 81.]

Senator THUNE. I want to put that out there in terms of a framework to each of you and would welcome your thoughts on these issues and the concept of a pass-through rate overall.

So, is there anybody who would like to take that on? I know I raised a lot of issues, but if you would care to comment, I would appreciate your thoughts.

Mr. TALISMAN. Senator Thune, thanks for the question.

Obviously, the argument for parity in rates must first take into account the fact that there is a double-level tax on C corporations. But also, designing a special tax rate on pass-throughs is difficult, as you allude to, and could be costly. So we would have to figure out a way of constraining it and making sure it is not prone to abuse.

Differentiating service income from capital income has been a nutty issue for all of us over the course of many years. We put out regs in the mid-1990s that subsequently got withdrawn that may actually provide some framework for what you are trying to do. But, again, I think it is a very, very difficult issue and difficult to constrain.

Senator THUNE. Ms. Olson?

Ms. OLSON. So I think that the report that you are inserting in the record from the Bipartisan Policy Center does a good job of setting out what the alternatives are as well as what the issues are. It is, indeed, a very complicated issue and one that will be difficult to administer going forward.

I want to go back to the 1986 Act and what happened in the 1986 Act. So in 1986, we cut the individual rate to 28 percent. We set the corporate rate at 34 percent and then fully taxed dividends and capital gains from corporations at another 28 percent.

The result of that disparity was that we drove all sorts of business out of the corporate sector and into the pass-through sector.

So the incredible growth that we have seen in S corps, LLCs, and partnerships started back in 1986 when the Tax Reform Act was enacted.

If we were to do corporate reform that made being in corporate solution much more attractive than being in pass-through solution, I think we would see, as we did back in the late 1980s, a migration out of pass-through form and into C corp form. So the problem could take care of itself, even without a special rate.

Senator THUNE. Thank you.

Mr. Solomon?

Mr. SOLOMON. I would just add that if one is going to level the playing field by eliminating from the code various deductions and preferences, presumably that would also apply to pass-through entities. So that may be a reason for lowering the rate with respect to pass-through entities.

The way partnership taxation works, as you know, is the distributive share flows out to the various owners of the entity. That is true for S corporations, it is true for partnerships, it is true for LLCs.

What you are going to have to do is then create various baskets of income. Once you identify the basket of income that is related to active business, presumably that would flow through and would enjoy the lower rate. But, as my colleagues have pointed out, to the extent it is attributable to services, you presumably will want to figure out a compensation element.

I think the biggest challenge is going to be to figure out what that compensation element is, and you could use a reasonable compensation approach, but a reasonable compensation approach, as we all know, is extremely difficult to administer. So it may require some sort of formula, for example, to treat a certain percentage of the income as being compensation income, or to figure out what capital contribution the owner has made. And to the extent of that, earnings on the capital contribution can enjoy the lower rate and the rest might be subject to the higher rate.

But it is a very difficult issue, to figure out exactly how that compensation element would be determined. I think that is the nub of the issue.

Senator THUNE. Mr. Chairman, I have another question. I am out of time, so I will submit it for the record. It has to do with a gig economy and the tax rules that apply there. I think we are going to have to take a whole new look at that, and we have a bill that does that. But I will submit that for the record.

Senator WYDEN. I am another who thinks that this is an area that needs to be looked at. So I appreciate that.

Senator Portman?

Senator PORTMAN. Thank you, Mr. Chairman.

This has been terrific, and I enjoyed hearing the testimony from all four of you. You are all four experts from various administrations, Republican and Democrat, and yet you all find consensus on the fact that not only is the code broken, but remarkable consensus on how to fix it.

As I listen to you and look at your testimony, I am reminded of the fact that this is not new. Let me quote Ms. Olson's testimony: "Your efforts are timely, particularly in light of the changing global

landscape. In reforming the tax system, we must be cognizant of the changes shaping other countries' tax systems, because capital is mobile and these changes are affecting investment decisions and capital flows in and out of the United States." Well said.

She said that 6 years ago at this same hearing where three of the four of you were present. And all of you said something similar. So, it is not just a question of finding common ground today.

I think you have been on this for quite a while, this basic proposition that we need to broaden the base, we need to lower the rate, we need a simpler system, we need a fair system. The devil is in the details, and the details are important.

And Senator Thune just mentioned one of them: how do you deal with the pass-through entities? If you have a lower corporate rate and the individual rate is relatively high, that differential causes some unfairness, in my view. And yet, the prescriptions to deal with it—and Mr. Solomon just talked about some of the ideas—do not take away the complexity of the tax code. So it is not just that solutions are difficult philosophically to find, it is that once you find them, the compliance is going to be a huge problem.

Let me just ask, do you all agree with that? Nodding of heads.

Ms. OLSON. Absolutely.

Senator PORTMAN. Okay.

So we have our work cut out for us. We need your help on that.

I want to go back to something that Senator Wyden said earlier about wage growth. I think this is really important. We have talked about this. We have known it for years, maybe even decades, since the 1986 Act.

We do not focus enough on "why?" And a lot of it has to do with the very real problems in our current economy, which are, yes, slight growth and better job numbers in the last several months when you take them in aggregate, but no wage growth. You know, when you take inflation into account, wages are flat, maybe even declining on average. This is one way to provide some economic growth, but also wage growth.

Kevin Hassett, who is the incoming Council of Economic Advisers Chairman, says with a 1-percent increase in corporate tax rates, wages decrease 1 percent. He has some good studies around that.

A 2009 study—a famous CBO study that I refer to a lot by William Randolph—says 70 percent of the burden on the corporate side, the higher taxes we talked about today, is on workers. In other words, you have higher pay, better benefits if you can deal with the fact that the United States does have the highest corporate rate of all the developed countries. Professor Mihir Desai, who came here in 2015 before this committee and testified, said 67 percent of the burden of our high corporate tax rate and the way we tax on a worldwide basis falls on workers.

So, you want to get wages up, which all of us do, and this is, I think, a great opportunity to do it. So I know about #TRIH—"tax reform is hard"—I assume that is what you are referring to. How about "TRIM," because that is easier to remember: "tax reform is mandatory." And we have got to do it.

So let me just ask quickly, if I could, about a specific issue, and that is interest deductibility, because that, along with the pass-through issue, has been a tough one for us.

Can someone tell me—maybe you, Mr. Solomon, because you mentioned it in your testimony—is the preference for equity financing versus debt financing an economic policy issue that you think is important to address, and if so, what would you do about it in the tax code?

Mr. SOLOMON. Well, certainly in the code today, as you all know, there is a difference in the treatment between a payment of dividends and the payment of interest. And it does create distortions, because having additional debt in our system encourages companies to take on debt. It may affect the relative portion of debt they would otherwise undertake, and could affect financial stability.

So that is an example of a distortion in the tax code that, if you would try to level the playing field, you would certainly pay attention to.

Senator PORTMAN. And what would you do about it? Senator Hatch and his team have been talking about actually making dividends deductible. That is one way to do it. Another way is to, as the House bill does, limit deductibility of interest. Any thoughts on that from the panel?

Mr. TALISMAN. Well, I testified in my testimony, Senator Portman, that I thought corporate integration was a better approach than going after interest deductibility. Based on my discussions with capital-intensive businesses, interest deductibility is actually more important to them than most other issues that we face.

I actually somewhat disagree with my colleague, here, Eric, because I believe that the debt bias has not led to overleveraging, based on the research that I have seen recently, in the nonfinancial sector. So we have to demonstrate that the distortion is actually having negative economic consequences.

Senator PORTMAN. Pam?

Ms. OLSON. Yes, I agree. I think that a better approach would be to go in the direction of corporate integration, rather than limiting the deduction of interest. There are a lot of businesses that depend on debt financing because they do not have access to the equity markets.

So those are just some of the things that need to be taken into account if you think about doing an interest limitation. Obviously, a lot of other countries have put limitations on interest deductibility. So there is a theme out there, internationally, of doing that.

But I think that the limitations that other countries have put on interest deductibility are not so severe that they actually impede companies from getting the financing they need and being able to deduct the expenses associated with it.

Senator PORTMAN. My time has expired, but if you would not mind, Mark, if you would give me your views on it in writing. And also, Eric, I see you want to follow up. You can follow up.

I am going to talk about the sweet spot, and where is it, and what is, actually, the best tax policy to address the issue of bias.

Thanks.

Senator WYDEN. I thank my colleague. That is an important area.

Senator Carper?

Senator CARPER. Thanks so much.

Welcome. We appreciate your being here today. We appreciate your service to our country, your continuing service to our country simply by your presence today.

My colleagues have heard me ask four questions with respect to tax reform proposals. And I have been asking these same four questions for a while, and I will probably take them to my grave. It may take that long before we actually do tax reform. So we will see—hopefully not.

I ask, is it fair? Does it foster economic growth? Does it simplify the tax code or make it even more complex? What is its fiscal impact? Those are the four questions I ask.

One of the questions I have to ask here today—and it is less a tax reform question, though, but it is one we need your input on. We underfund the IRS. We ask them to do more than is humanly possible.

We change the tax code at the last minute, and we expect them with not enough people, not enough money, not enough technology, to somehow be able to make it all work.

Any advice for what we should do with respect to funding the IRS? Please?

Mr. MAZUR. Sure, Senator Carper. One of the ways I like to think about the Internal Revenue Service is, it is like a giant credit card company, in that what they do is bill people and make collections.

Senator CARPER. In Delaware.

Mr. MAZUR. Exactly. And so you know how it works. They bill people, they make collections. They go after people who do not pay.

Underfunding the IRS is like underfunding your accounts receivable department. No rational business would do that. And I think there are a number of studies that show——

Senator CARPER. That is a great line. I am going to use that.

Mr. MAZUR. Okay. Feel free. It is not copyrighted.

But there are a number of studies that show that if the IRS gets an extra $1,000, they will bring back an extra $4,000 or $5,000 in revenues. So it really pays for itself and then some.

Senator CARPER. Good. Thanks.

Anyone else? Please, pile on; go ahead.

Mr. SOLOMON. The IRS, of course, as we all know, collects the revenues that are needed to fund our government, and so it is very important that the IRS have the capability, both in services and enforcement, to collect the revenues called for by the law in a fair and efficient manner.

Senator CARPER. All right.

Others, please?

Ms. OLSON. I agree with all of that. I have been thinking back to a story that involved a credit card company that Senator Portman used to tell back in the late 1990s when he was part of the IRS restructuring commission, or the group that looked at restructuring the IRS, about the kind of service that you expect.

And it was, American Express does not come back to you 2 years later and say, "What about that bill?" We really need to fund the IRS to make sure that they have the technology that they need and to make sure, particularly, with all of the identity theft and cybersecurity issues going on, that they are able to safeguard the infor-

mation that they collect. So it is really important to make sure that they are adequately funded.

Senator CARPER. Good. Thank you.

One more.

Mr. TALISMAN. Yes, I agree with Mark about the one out of four. I mean, obviously, if we fund the IRS, we can reduce the tax gap. Reducing the tax gap, I think, actually helps with the perception of fairness of the code.

What happened, obviously, in 1986, one of the things we did, was we shut down loopholes. We are also putting additional responsibilities on the IRS without increasing their funding.

One example of that, obviously, is health-care reform. We run a lot of health reform through the Service, and yet we have not increased their funding. In fact, we have cut their funding.

Senator CARPER. That is a good point.

Let me ask you a question. I ask a lot of "yes" or "no" questions, but this one—I would be happy with a "yes" or a "no" on this one, if you will.

Do you all think that the administration has responsibility here to put out a rigorous, well thought-out opening offer on tax reform, something beyond what I think are rather vague general principles? Please?

Mr. MAZUR. Yes.

Senator CARPER. Thank you.

Mr. TALISMAN. Yes. I think it is essential, because I think it is essential that the President and other leaders who want to push for tax reform market whatever they are trying to market to the American people and demonstrate that it is going to increase our standard of living, especially for the middle class.

Senator CARPER. All right. Thank you.

Others, please?

Ms. OLSON. I think the Treasury Department has enormous resources that could offer a lot in the consideration of tax reform.

Senator CARPER. Good.

Thank you.

Mr. SOLOMON. It is important that both the Congress and the administration work together in a bipartisan way to achieve tax reform.

Senator CARPER. How important is it that tax reform does not further balloon our Nation's deficit? I just saw a news report last week that said the budget deficit, which would have hit about $1.4 trillion close to 10 years ago, during the bout of the Great Recession, went down, down, down, and bottomed out at about $400 billion now. And last year it was up to about $575. The administration, so far, is heading for adding about another $100-plus billion to that. For the current fiscal year we could be looking $700 billion.

People do not talk about that anymore, but the idea of just simply cutting taxes by another couple of trillion dollars, is that something we should just proceed to without much thought?

Go ahead. Anyone?

Mr. MAZUR. Obviously, I think you need to be concerned about the medium- and long-run fiscal situation. So unpaid-for tax cuts that make the situation worse is just like digging the hole deeper.

Senator CARPER. All right. Thanks.

Others, please?

Mr. SOLOMON. Yes, as I said in my testimony, our tax reform should be achieved in a fiscally responsible manner, and we all recognize that spending is going to continue to increase, including mandatory spending. We need to do reform, but we have to do it in a way that does not disadvantage us in addressing our long-term budget imbalances.

Senator CARPER. Well, thanks.

Briefly, two others, please, if you would?

Ms. OLSON. So I addressed this in my written statement as well. To my mind, we need to look at both sides of the ledger, both the spending side as well as the revenue side.

And clearly, spending is growing out of control, and we really do need to take a hard look at it. But we have to be fiscally responsible. Whatever Congress agrees to spend, we have to fund. Tax reform has to be sustainable. That means, in part, generating enough revenues to cover what we agree to spend.

Senator CARPER. Good. Thank you.

Yes, sir?

Mr. TALISMAN. I agree. That is what I said in my testimony as well.

Senator CARPER. All right.

I would just say to colleagues, these folks are brilliant, are they not?

Senator WYDEN. Yes, they are.

Senator CARPER. We should bring you back.

Senator WYDEN. I thank my colleague.

We are going to have to move on, in order to get everybody in before 11.

Senator Cassidy?

Senator CASSIDY. Thank you all for being here.

The highly mobile intangibles—Microsoft can move licenses to their Irish subsidiary, and they do not pay a single cent of tax. We have seen a lot of these issues.

As one example—but others do it as well—U.S. multinationals use international tax rules to shift IP and associated earnings offshore. How do we handle this? If we are going to do tax reform, is it just a matter of lowering the corporate rate so it does not profit them to move overseas? If we cannot, because you mentioned earlier that it is so expensive to lower the corporate tax rate—can we get it down to Ireland's? Maybe not. So how do we balance these highly mobile intangibles and the ability of folks to move overseas? Just kind of down the row, if you will.

Mr. TALISMAN. I think that, obviously, there are approaches that are being looked at in international tax reform regarding the structure of a minimum tax that could help address those issues. We, obviously, do have to look at our transfer pricing and cost sharing rules and make sure that they work appropriately, but I think the chairman and Senator Enzi both had a carrot and stick sort of approach to encourage IP to be redomesticated into the United States and taxed at a rate that was commensurate, that would give us the first right of taxation and not give Ireland the first right of taxation.

Ms. OLSON. So the first and best anti-base erosion measure is a well-designed tax system. If the tax system is well-designed, it is going to attract income back to the country and eliminate a lot of the issue.

That has to start with a rate that is competitive with the rest of the world. No, that does not have to mean Ireland's 12.5 percent. But we have to get somewhere in the ballpark, and right now we are at the top of the heap.

So that is the first thing. The second thing that I think we should look at is a consumption tax base, because a consumption tax base is what other countries use to ensure that they are taxing a share of the value that is delivered in goods and services.

Senator CASSIDY. Well, let me interrupt, just because a consumption tax—I cannot help but note that we are more prosperous than every country which has a consumption tax. And if we are going to speak about taking care of the working middle-class families, they are the ones who, obviously, pay a greater percent of their income in a consumption tax.

Obviously, you are taxing consumption. Now, you could hold them harmless by some type of rebate. But again, I have to note that folks in our kind of lower socioeconomic class have more disposable income because of the absence of a consumption tax. I just, again, note that as you answer, it does seem a little bit like we have conflicting kind of goals and priorities.

Ms. OLSON. There are lots of ways to address the potential regressivity of a consumption tax. They include lessening the tax burden in other ways. So that could be done through an expanded Earned Income Tax Credit. That could be done by taking more people off the income tax rolls. So there are lots of ways to deal with those issues.

I do not necessarily always agree with economists, but I do in this case think they are probably right when they say that a consumption tax base is more conducive to economic growth, and the best thing that we can do for the middle class is to do things that will encourage more economic growth.

Senator CASSIDY. So let me ask one more time, because, if you look at a consumption tax, I have to admit the economists think, okay, if I lower it here and I raise it there, that has no influence on behavior.

As it turns out, if I go out and something is priced 20-percent higher than it formerly was, or whatever you pick your VAT to be, I may not buy it even though I have more money over here. And it seems as if we see that countries like China and Germany that have a consumption tax, they have a higher rate of savings, which they promote—and an export-based economy—but they do not consume as much.

So again, the economists, of course, would say that it is all a wash. I am not quite sure that practically speaking, it is a wash for the person looking at the higher price. I digress.

Gentlemen?

Mr. SOLOMON. I would just add that a lower corporate rate will reduce some of those incentives. The question is, how low can we get the rate down? If the rate is still 25 percent, we are, neverthe-

less, going to need some base erosion rules, and there are a number of base erosion rules that might be considered.

Senator CASSIDY. And you all know the technical aspect to this far better than I. By the way, I am just learning from you all. I am not trying to challenge just to be difficult.

It seems like some of these high-tech companies have very low effective tax rates, very low effective tax rates. And so, how much lower can you get than zero?

So they are moving their IP, and maybe you can say, well, that is what is lowering their effective tax rate. But even on their income in the United States, they have a low effective tax rate. I think I read one year Apple paid zero. And GE pays, in a few years, zero.

So, any comment on that? Again, how low can you go?

Senator WYDEN. You have to be quick, folks, because we have a lot of colleagues waiting.

Mr. MAZUR. Okay, so just one quick comment on that. If you are going to move to something like a territorial system, you need to be concerned about base erosion issues, and that is what my colleagues have said.

One approach could be to set a global minimum tax. And so, if you have a global minimum tax of, say 15 percent, then no matter where the income is earned, they pay at least 15 percent. They pay zero in the Cayman Islands. They pay 15 percent to the U.S. And that is a way to kind of stop the race to the bottom and keep at least some minimal amount of tax on those transfers of intangibles.

Senator CASSIDY. Thank you.

Senator WYDEN. All right.

Senator Cardin?

Senator CARDIN. Thank you, Senator Wyden.

Let me thank all of our witnesses. I think this is extremely helpful. Tax reform, in order to be successful, must have certain conditions met. One is an open process, transparency. We have been talking about that. This hearing helps us in talking out some of these issues. So I want to thank the chairman for convening this hearing. I hope this is how we will proceed with tax reform: in an open way with this committee being engaged.

Secondly, it has to be fair, which means middle-income taxpayers should not pay any more of the cost of our government percentage-wise than they are paying today. And I think most members of Congress agree on that. We want to make sure this is not an additional burden on middle-income families.

And third, we have to raise the revenue that we say we are going to raise so we do not add to the deficit.

So I have listened to the exchanges about the desires to reduce the marginal business tax rates, and I agree with that. Senator Cassidy's point is well-taken, because there are distortions as a result of high marginal tax rates. Planning is done in order to avoid the taxes, which is not always in the best economic interest of our country.

And I also listened to the exchanges with other of my colleagues as to how we could get down the business tax rates within the income tax code. And then Senator Warner's point about every one of these issues being difficult to achieve is correct.

When you have winners and losers, the losers are not going to be quiet. And it is going to be very difficult to get that done—to get up to the revenues you need—and if you just deal with the C rate, a 10-percent reduction is about $1 trillion. If you deal with those who have pass-through incomes or use the individual rates, it is about $1.6 trillion to get a 10-percent rate reduction, which is not easy to find real offsets for to equal those numbers, which brings me to the exchanges we had with several of our colleagues—and I am glad they were talking about it—concerning the consumption taxes.

I think there is no other way to get competitive marginal business tax rates in this country without bringing different revenues into funding government other than income tax revenues.

Ms. Olson, I appreciate your written statement where you say economists across the political spectrum have concluded that consumption-based taxes are a more efficient way of raising revenue in an open economy than the corporate income tax.

So, the major concern we heard today is, will middle-income families pay more? That is something which I said I would not support. So I just urge my colleagues to take a look at the progressive consumption tax that I filed, working with those who do our scoring at the Joint Tax Committee, to make sure the middle-income families will not pay any more than they are paying today.

Ms. Olson, you are absolutely correct. There are ways of adjusting other parts of the income tax code to make sure that this is progressive. But then there is concern on the other side that we will raise more revenue than we say we are going to raise. That has been an issue I have heard from many of my colleagues: that it will grow government.

One of the conditions is, we raise the revenue we say we are going to raise. And in my progressive consumption tax, we have a way of rebating additional revenues if they are over what we say we are going to raise, so therefore, it will not be a justification to grow government. I want to make sure we have the revenues we need, but not an exercise of growing government through tax reform.

So, Ms. Olson, what am I missing here? Is there a way of getting this done that is easy within the political system, without bringing in consumption, to get down business tax rates? And I know the old saying about the VAT tax. Some people have come out against it. I do point out, as you did, this is a credit invoice method, which is different than a value-added tax.

So would you just comment as to whether the observations I have just made are accurate? How do you see this playing out?

Ms. OLSON. I agree with you, Senator Cardin. I think that adding a consumption tax like a value-added tax to the portfolio of taxes that we use would go a long way towards making tax reform easier, because it would allow us to keep something like our current base and then to lower the rates in a way that would make the U.S. more competitive as a place to invest.

As I look out into the future, we have a rising difference between what we expect to be collecting in revenues and what we expect to be spending. And we have to find some way, in addition to making tax reform easier, to close that gap, and a consumption tax seems

to me to be something that is a very viable alternative and should be carefully considered by the committee.

Senator CARDIN. Thank you. I appreciate that.

Thank you, Mr. Chairman.

Senator WYDEN. Thank you.

Next is Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman, or Mr. Ranking Member.

Mr. Mazur, you made a comment to Dr. Cassidy about imposing a minimum global tax rate of 15 percent. How does that work when the companies invert and are no longer American companies?

Mr. MAZUR. So the issue is, how do you tax companies where you have the jurisdiction to tax them? So in the case of a company that, say, was a U.S. company acquired by a foreign company—this still is a U.S. entity that is subject to U.S. tax, and what you want to ensure is that there are sufficient base erosion rules so that that U.S. entity cannot just shift income that really is subject to U.S. tax abroad and have it subject to no or low tax rates abroad.

So you really need to have tight base erosion rules. One approach in the case of shifting intangible income, intangible property income, is to have something like a global minimum tax, so that no matter where the income is pushed around the world, it is still subject to at least some minimal rate in the U.S.

But you need additional tools as well, like a belt-and-suspenders approach, in order to make sure that you have enough of a hook on the U.S. operations that you can actually subject them to tax.

Senator SCOTT. All right. Thank you.

The next question is for Ms. Olson, and perhaps Mr. Solomon.

The south has become a manufacturer's haven. We have a number of companies that do business around the world, whether it is Boeing or GE—GE is selling major turbines around the world.

The current system of global taxation seems to be a major impediment to growing jobs in our economy here at home, and specifically in the south. Can you talk for just a few minutes about the improvements that could be made to our national economy if we went to a specific territorial system and allowed for large companies to bring home their resources to build plants here, hire more employees here, as opposed to the challenge that we face around the world today?

Ms. OLSON. Certainly. Thank you, Senator Scott.

Two issues are the high rates, and then our worldwide system. And when you put those two issues together, what you end up with is a lockout effect that several of us have talked about already in our testimony.

We really do need to get rid of the worldwide system, which I think is the worst of all possible worlds, a system that does not raise a lot of revenue because it does not encourage earnings to come back and results in income being invested somewhere other than the United States.

So I think key here is to look at bringing the corporate rate down to something that is competitive with the rest of the world and then to fix the international rules so that we do not have the lockout effect.

Senator SCOTT. Thank you.

Mr. SOLOMON. Yes, just to briefly add to that, an example of the situation that you are positing is a situation where you have a U.S. company wanting to do business in a foreign country. We have a worldwide system, where if money is brought back, it is subject to tax. But, if there is a company from another country, from a third country, trying to do business in that particular second country, it will not be subject to the repatriation tax.

So if both are trying to compete for an investment in a particular country, a company that is in a country that does not have a repatriation tax will have an advantage.

Senator SCOTT. Thank you, sir.

In my last minute or so of questions, if you will walk with me through the process of, if we were successful at reducing our corporate rate from 35 percent down to 22/23 percent, if we allowed for permanent repatriation—we currently have 6 million jobs that are open. So we would create a million more jobs. If we do not end the conversation in tax reform, regulatory reform, with making sure that our workers are able to do the work that we are creating, I think we have really shortchanged our economy.

So my question really is on using the tax code, if we are not able to achieve the elimination of all credits—would we want to focus more of our attention on apprenticeship programs and other vehicles to make sure that the workforce that we have is prepared for the new opportunities in a world that has been successful at tax reform?

Ms. OLSON. Yes, I think we have probably focused too much on people going to college, which does not necessarily prepare them for the jobs of the future, the jobs that are available today. So doing more to focus on apprenticeship programs, on technical schools, community colleges that prepare people to take jobs, and then also something that focuses on the fact that we need to constantly be retraining because the world is changing so much and the jobs that are out there are changing so much, the skills that are necessary.

Senator SCOTT. Thank you.

Senator WYDEN. Thank you, Senator Scott. You will have a lot of us on this side of the aisle interested in the apprenticeship issue. I am glad you brought it up.

Senator McCaskill?

Senator MCCASKILL. Thank you, Senator Wyden.

Let me ask a "yes" or "no" question to all four of you, since all of you represent different parties, two and two in terms of who you worked for. So you are a bipartisan panel. A lot of us are spending a lot of time yearning for the bipartisanship right now in the United States Senate. So let me ask you all a "yes" or "no" question. Do you believe that a major tax reform bill that restructures our tax code should be bipartisan?

Mr. MAZUR. Yes. If you want it to be a durable reform, it should be bipartisan.

Mr. SOLOMON. It would be preferable if it were bipartisan.

Ms. OLSON. What Mark and Eric said.

Mr. TALISMAN. And I included that in my testimony.

Senator MCCASKILL. So, the chairman is not here, but I would once again turn to the chairman and say to the chairman, "Mr. Chairman, will we have a hearing on the tax reform bill? Will the

Republicans allow us to have a hearing in the Finance Committee on the proposal that is going to restructure our tax code? Is that going to be possible?" Do you have any idea as the ranking member, Mr. Wyden?

Oh, good. Here is the chairman. Mr. Chairman, I am asking my question again. I am asking you, Mr. Chairman, will we have a hearing in the Finance Committee on the tax reform proposal that you all plan to vote on on the floor of the Senate?

The CHAIRMAN. Well, I would like to. I do not know as of right now.

Senator MCCASKILL. Would not that be normal order?

The CHAIRMAN. Yes and no. It depends. It depends on who is running things. I have seen—there were some Democrat times when it was not regular order, but be that as it may, I would prefer to do hearings if we can.

Senator MCCASKILL. Well, that is great to hear, Mr. Chairman.

The CHAIRMAN. I am not saying we are going to, but I would prefer it.

Senator MCCASKILL. I am a new member, and I had this idea that I was coming to this committee to actually consider important items of finance to our government, and there is no more important item of finance to our government than the structure of the tax code. There is nothing that is more impactful on our economy or on businesses and job creation in this country than the tax code.

If we cannot have a hearing in the United States Senate on the Committee on Finance, on tax code reform, then I do not know why we have this committee. It does not make sense to me.

So I am very hopeful, Mr. Chairman, that there will be a proposal. You said in your opening statement you hope the Democrats want to work on tax reform. You were not sure that all want to work on tax reform; you hope some do. I can assure you, Mr. Chairman, all the Democrats want to work on tax reform. We all want a seat at the table, and so I am imploring you to use your influence on Senator McConnell to allow us to have a hearing in the committee.

The CHAIRMAN. Well, you would be idiots if you didn't want to work on tax reform. And I know you all do, and I intend to see that you do. That is what this hearing is about, by the way.

Senator MCCASKILL. We do not have a proposal, Mr. Chairman. This is all hypothetical and policy, which is great. I am glad we are having it, but this is not on a proposal that would actually change the tax code. We have nothing in front of us in terms of a proposal. Nothing from the administration, nothing from the Republican majority. It is a far cry from the Finance Committee hearings that you have sat through for decades in this Senate that have looked at the specifics of legislation.

The CHAIRMAN. Well, I am listening.

Senator MCCASKILL. Okay, good. I am so glad you are.

Let us talk about temporary tax code changes, versus permanent. If we go through the partisan exercise of reconciliation, those tax code changes would be temporary. They would only be good for 10 years.

I would ask any of you to comment on whether or not it would make sense to make major changes around the deductibility of in-

terest or a territorial tax system if the business community knows these are only for a 10-year window?

Mr. MAZUR. I would say I think a permanent set of changes is preferable, that businesses want certainty. They are making long-term decisions. They basically deserve to know what the rules are going to be in years 11, 12, and 13.

Mr. SOLOMON. Certainty is very important, so permanence is better.

Ms. OLSON. And the more significant the change, the more important something being durable, long-term, and sustainable is.

Senator MCCASKILL. As an example, if we were just doing rate changes, that is one thing, but if we are doing structural reform, that is a whole other set of challenges to do on a temporary basis.

Ms. OLSON. It will have a much stronger economic effect if it is lasting reform.

Mr. TALISMAN. I agree, planning is very difficult if the changes are not permanent. And as you say, it is important for structural changes to be permanent.

Senator MCCASKILL. Another good reason that we should not be using reconciliation to make major tax structure changes, since it is only a temporary change in the tax structure.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heller?

Senator HELLER. Mr. Chairman, thank you. I want to thank you and the ranking member for holding this important hearing. I want to thank our witnesses, also, for being here. I think I may be the second to the last to question you today. So I am going to anticipate that most of the questions I am going to ask you, perhaps have already been asked or are a part of your testimony. But I am going to ask you anyway.

I am from the State of Nevada, and it was hit particularly hard during this Great Recession. I am seeing a lot of recovery, but we have a long way to go.

The question is, what is standing in the way of full recovery, and I do believe that a tax reform package, comprehensive or changes in our tax code, would go a long way to solving some of these problems.

I want to thank the chairman for holding this hearing. And in my discussions with him, and with the White House and with the House of Representatives—they do want to have something in concept by somewhere around September 1st so that we can have open hearings. And I know the tendency for the chairman is to have open hearings so that we can discuss in detail some of the concerns that my friend from Missouri may have.

But back in 1986, one of the key elements of that act—which was the last time, of course, we had tax reform—was to broaden the tax base, to reduce tax rates, and to simplify the code. I guess my question for the panelists—and I will start with you, Mr. Solomon—is whether or not you believe that those three key points, broadening the base, reducing rates, simplifying the code, are still the key moving forward on this proposed movement of tax changes?

Mr. SOLOMON. I think they are very important. I also think revising our international tax system is a very important part of this

because of all the cross-border business activity that occurs and will be increasing over time.

Senator HELLER. We talk about these words, "broadening the base, reducing the tax rate, simplifying the code." Easy to say.

Ms. Olson, what does that actually mean for the average taxpayer?

Ms. OLSON. So, for the average taxpayer, it might not have an effect, because the average taxpayer today is not necessarily affected by a lot of things that are an issue here. They may not be itemizing deductions, for example. So, if you do a lot of simplification, you could do some things like greatly expanding the bracket for the standard deduction. That would take a lot of people entirely out of itemizing deductions, and that would have a very positive effect on them and reduce the recordkeeping burden and make the tax code a lot simpler.

So there are things that we can do that would involve broadening the base, lowering the rate, greater simplification—all good things to do that would be positive for that average taxpayer.

Senator HELLER. So, I just do not want to make this an exercise about Washington, DC. I want the average taxpayer out there to know that if we go through this activity and this process, that there is something at the end of the day that works for them.

I had a meeting at the White House, talking to the Treasury Secretary, and one of the things that he mentioned—I cannot remember exactly what his percentage was. It was 85 percent, 90 percent, but he wants that percentage of Americans to be able to calculate their own taxes.

In other words, it is going to get complicated for some, but for the average American, they should be able to calculate their own taxes. Is that a goal that is a worthy goal moving forward?

Mr. SOLOMON. Simplification is definitely a goal that we should try to achieve. And making Americans think that the tax system is fair by understanding what their tax obligation is and being able to fill out their own forms is very important.

Mr. MAZUR. I think I agree with that. I think that one of the important roles of the tax system—it is like an annual civic ritual that we all participate in. If you understand what it is, you can appreciate it more. And I think you can use technology to do this.

People talk about filing a tax return on a postcard. My kids have to go to the museum to find a postcard, right? So they would like to file their returns on an app where everything gets downloaded electronically. So, if you could think a little bit forward, you could probably have a situation where it is simple, you understand what the rules are, you know how to comply.

Senator HELLER. Okay. So we get over that hump and they are thrilled, it is simplified, we have done a great job. In your opinion, what would you anticipate GDP to be if we do this right?

Mr. MAZUR. Look, we at the Tax Policy Center have done a fair amount of analysis on dynamic scoring. If you are talking about doing something in a revenue-neutral way, you will improve incentives a little bit. You should improve the economy a little bit.

You are not going to get a giant improvement in the economy. I think one of the things that is a bit unfortunate is, people seem to sell dynamic scoring effects as giant effects. They really are not

going to be that large. We have a $20-trillion economy. You are not going to move the needle all that much. You can move it some.

Senator HELLER. Can you quantify it at all?

Mr. MAZUR. So, when Congress passed the PATH Act in 2015, the Joint Tax Committee did an estimate of this. I will make the numbers up, but it is about right. With conventional scoring it cost around $700 billion; with dynamic scoring it costs around $600 billion.

And that was doing things like making the R&E credit permanent and some other incentives permanent that actually should have an effect. So one-sixth or one-seventh of the amount.

Senator HELLER. Mr. Chairman, my time has run out. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman.

Mr. Chairman, when I was a young Congressman, I happened to see tax reform and see it pass in 1981. And then some of the things that were mistakes in the 1981 bill were changed in a comprehensive tax reform in 1986. You could not pass either one of those without bipartisanship.

I would like to ask you all, with your experience and your expertise on tax, do you want to venture a comment about passing it just with one party as opposed to in a bipartisan way?

Mr. MAZUR. Senator Nelson, I think if you want tax reform to be durable and to last for decades and have some positive effect, you want it done in a bipartisan way.

Senator NELSON. I think that is pretty obvious. I thank you for reaffirming that.

May I ask your opinion on—what would you say is a realistic target for getting the tax rates down to, both corporate and individual, to still have some money left over for a significant infrastructure package?

Mr. MAZUR. I talked a little bit about that. The Obama administration did a business tax reform plan, and could find a way to get, in a long-term, revenue-neutral way, the corporate tax rate from 35 percent to 28 percent and to generate a couple hundred billion dollars for infrastructure.

So that is 7 percentage-point reduction in the corporate rate. On the individual side, I think it goes back to the points that Eric and Pam were making: it basically depends on how bold you want to be on reducing tax expenditures on the individual side as to how low the rates can go.

Senator NELSON. Does anybody else want to venture a guess on the individual rate, because on the corporate side, as Mr. Mazur has just mentioned, you would only end up getting, under the Obama proposal, about a couple hundred billion. But we have trillions of dollars of needs in infrastructure.

So what would you have to take individual rates to to have, let us say, a trillion dollars for infrastructure?

Ms. OLSON. That sounds to me like you are talking about taking rates up if we are going to produce money for infrastructure.

Senator NELSON. No, no; in tax reform.

Ms. OLSON. Okay, so in tax reform. In Dave Camp's 2014 Tax Reform Act, it took the corporate rate down to 25 percent, took the individual rate down to 35 percent, and earmarked some revenue from repatriation of offshore earnings for use as infrastructure spending.

Note that there is an awful lot of capital that would be invested that is offshore. Some of it is U.S. corporate cash. There are also a lot of other funds available.

I was over in Asia last week and heard an awful lot about capital available for investment in the United States, in particular with an interest in investing in infrastructure in the United States. If we get our tax system reformed, we may need some more treaties, and we may need to address some issues in the tax code that are impediments to infrastructure, but I think there is an awful lot of capital around the globe that would like to help with our infrastructure needs here in this country.

Mr. SOLOMON. As I mentioned before, earlier this morning, how far we can get the individual rate down depends upon what deductions, credits, and other incentives you would eliminate.

Senator NELSON. That is correct—the tax expenditures.

So I will just summarize my comments, my thoughts here, which is why I asked the question of you all. If you get rid of a lot of the tax expenditures, which will allow you to then have the revenue to lower the rates, both corporate and individual, you can design that in a way that you still have revenue left over, over a 10-year period, in order to invest in infrastructure.

Now, the only way you are going to get to that goal is to do it bipartisan. And that is the bottom line of my comments.

Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you, Senator.

We want to thank this eminent group of people, of experts, for taking time to be with us today and to give us their excellent testimony. We are grateful to you. Most all of you have been here before the committee a number of times, but we just cannot tell you what it means to us.

[Whereupon, at 11:12 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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 entitled, "Comprehensive Tax Reform: Prospects and Challenges":

Welcome, everyone, to our first hearing of the day, where we will discuss the ongoing effort to reform our Nation's tax code. We have a distinguished panel of bipartisan experts before us today to help shed some light on issues surrounding tax reform. I look forward to a productive discussion and appreciate your attendance here a bit earlier than our normal meetings.

In 1984, President Reagan called for a reform of the tax code. He laid out three main goals for tax reform: fairness, efficiency, and simplicity.

Those three goals are as relevant today as they were a generation ago. For our current efforts, I would add a fourth goal: American competitiveness. This goal is essential in today's global economy, as we must also consider what is happening outside our borders.

When discussing tax policy or legislation, it's very easy to find oneself heading down byzantine paths of ever-greater complexity, but I think we would do well to keep focused, and to frequently remind ourselves of these basic principles.

Therefore, I'll repeat them: fairness, efficiency, simplicity, and American competitiveness. The Tax Reform Act of 1986 is generally considered to be a great success.

However, one question people should ask themselves is: if the law we passed in 1986 was such a success, why did it disintegrate so quickly?

Obviously, there are a number of competing interests out there, with many of them focused on narrow provisions or benefits in the tax code. Some of these interests have employed efficient lobbyists to make compelling cases for changes while others have elected efficient legislators who have done the same.

That's one reason for the more or less constant change we've seen to the tax code since 1986. Another reason might be that the theoretical underpinnings of the 1986 weren't as sound as many assumed.

For one thing, the 1986 reform was a shift toward pure taxation of income. But, in the last couple of decades, there has been an increasing awareness of the efficiency of taxing savings and investment lightly (or not at all), and instead basing the tax system on consumption. And indeed, a number of the subsequent changes to the tax code could be described as a shift away from taxing income toward taxing consumption. This helps to explain things like decreased tax rates on capital gains and dividends, more rapid depreciation schedules, and more qualified retirement plan options. Many of the major reform proposals we've seen in recent years—including the House's Better Way Blueprint—would take us further in that direction.

And while some of these changes have been very good, the piecemeal fashion in which they have happened was not consistent with simplicity. And many of the changes have been bad.

Another way of looking at the unraveling of the 1986 tax reform law is that it had a sound theoretical basis at the time, but technological changes in the intervening decades have required us to make changes in the years since. For example,

the tax base is far more mobile today than it was in 1986. And a mobile tax base is inherently less reliable, making efforts to heavily tax highly mobile assets an exercise in futility.

Whatever the case, we know that the myriad changes to the tax code in the past 3 decades have left us with a status quo that is simply unsustainable.

American families, individuals, and businesses collectively spend hundreds of billions of dollars a year—not to mention countless hours—simply trying to comply with the tax code.

Tepid growth rates for the U.S. economy have seemingly become the new normal for some. America's multinational businesses find it difficult to compete abroad and are often targets for acquisition by foreign companies.

All of this should be unacceptable to every member of the Senate. Senator Wyden was correct when he recently described the current tax code as a "rotting economic carcass."

There is no longer any question as to whether we should reform the tax code. The only questions remaining are "how?" and "when?"

For this reason, we are engaged in a long-term effort to fix these problems. And, in my view, the momentum in favor of comprehensive tax reform is stronger now than at any point since the 1986 reform was signed into law.

I know Republicans—both on this committee and elsewhere—are united in our commitment to fix our broken tax system and efforts in both chambers of Congress and on both sides of Pennsylvania Avenue are ongoing.

My sincere hope—which I've repeated numerous times—is that our Democratic colleagues will be willing to join in this effort. Tax reform should not have to be a partisan exercise. Indeed, the negative impact of the status quo falls on Republican and Democratic voters alike. So, we should all be willing to work toward solutions.

I know that many of my colleagues on the other side of the aisle recognize the need for reform. However, much of the Democratic leadership's rhetoric on this issue has been less than encouraging.

We've heard condemnations and claims about tax plans that do not yet exist.

We've heard demands—sometimes stated as preconditions to any bipartisan cooperation—for concessions that are unrelated to tax reform.

And, on a similar note, we've heard demands that Republicans make significant procedural concessions for moving a tax reform bill as a prerequisite for any bipartisan engagement on the substance of potential legislation.

I won't belabor this issue too much at this point. I'll simply say that, historically speaking, this is not how we've worked on bipartisan tax policy, and I hope that the statements we've heard from some of the Senate Democratic leaders discouraging bipartisan efforts on tax reform do not reflect the views of all our Democratic colleagues.

Today, we have a panel of four very skilled experts who represent both parties—they are all former Assistant Secretaries of Treasury for Tax Policy. They've been on the front lines of tax policy for some time, and I am certain that their insights can help us today as we work to address both the shortcomings of our current tax system as well as the divisions that could hamper our tax reform efforts.

With that, I'll turn to Senator Wyden.

PREPARED STATEMENT OF HON. MARK J. MAZUR, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2012–2017, DEPARTMENT OF THE TREASURY

Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for inviting me to appear today to discuss issues surrounding broad-based tax reform. The views I express are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

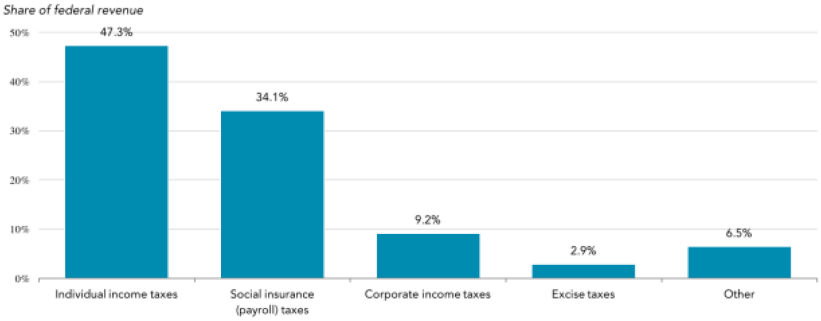
BACKGROUND

There is a broad consensus that the U.S. tax system is in need of reform. The tax system raises more than $3 trillion a year. Almost half (47 percent) comes from individual income taxes, over a third (34 percent) comes from Social Security and Medicare payroll taxes, just under 10 percent comes from corporate income taxes, and about 2–3 percent comes from excise taxes (*see* figures 1 and 2; note that the small percentage for excise taxes translates into almost $100 billion a year).

FIGURE 1

Sources of Total Federal Tax Revenue

FY2016

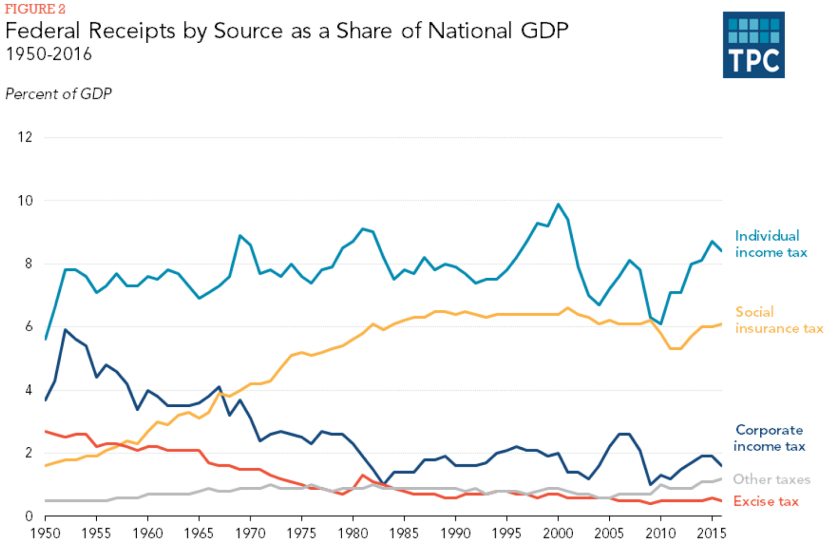


Source: Office of Management and Budget, Fiscal Year 2018, Historical Tables, Table 2.1.

FIGURE 2

Federal Receipts by Source as a Share of National GDP

1950-2016

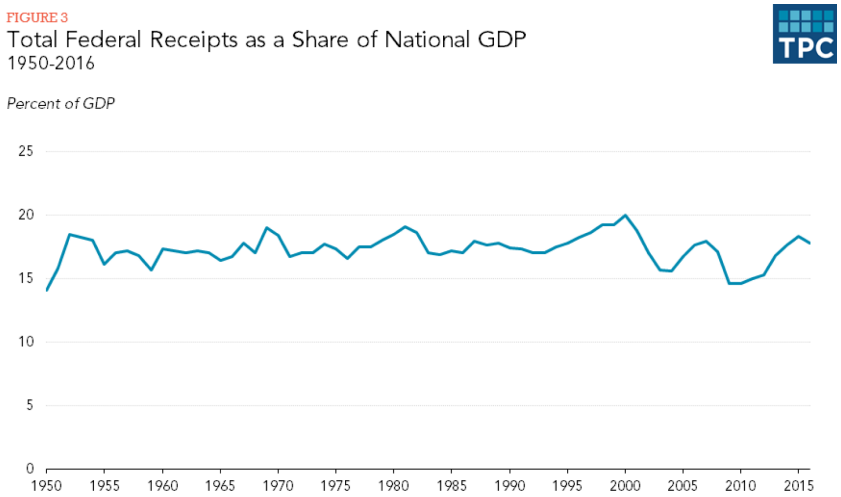


Source: Office of Management and Budget, Fiscal Year 2018, Historical Tables, Table 2.3.

The Federal tax system has raised aggregate revenues of between 15 and 20 percent of GDP for most years in the last couple decades (*see* figure 3).

FIGURE 3

Total Federal Receipts as a Share of National GDP
1950-2016



Source: Office of Management and Budget, Fiscal Year 2018, Historical Tables, Table 2.3.

One goal of tax policy is to raise the revenues needed to pay for the goods and services the public demands from the Federal Government. By this measure, the United States is falling short, running persistent budget deficits. The time the Federal Government ran a budget surplus in the past four decades was in fiscal years 1998–2001, when revenues as a share of GDP were around 19–20 percent. Given the changing demographics, it seems almost unconceivable that the Federal budget can be brought into balance at smaller amounts of revenue as a share of GDP. The implication is that fiscally responsible tax reform would likely raise aggregate revenues as a share of GDP above current levels in the longer run. To put it another way, net tax cuts in the medium and long run will worsen the Federal fiscal situation. Therefore, responsible tax reform should raise at least as much revenue as current law.

The U.S. tax system was last overhauled in 1986, and the current system, especially as it applies to business income, is woefully out of date. Three decades of changing business practices, increased globalization, changing tax laws in other countries, and expanding aggressiveness in tax-planning activities have led to a system with very many critics and precious few defenders.

Concerns about the business tax system include a maximum statutory corporate income tax rate that is among the highest in the world; special tax provisions that enable many firms to pay an effective tax rate far below the statutory rate; incentives for U.S.-based multinational firms to shift profits abroad and to claim the profits are permanently reinvested there; incentives for multinational firms (both domestic and foreign-parented) to locate deductions in the United States and income in lower-taxed jurisdictions; incentives for certain firms to organize as pass-through entities in order to avoid corporate-level taxation; and immense amounts of complexity that make compliance difficult and raise questions about the tax system's administrability and fairness.

But the corporate income tax raises approximately $300–400 billion a year, so it is an important revenue source for the U.S. Treasury. Moreover, it serves as a backstop for other taxes, such as the individual income tax. Maintaining this revenue source while addressing its most glaring inefficiencies is a key challenge for business tax reform.

PRINCIPLES OF TAX POLICY

Tax policy is guided by three basic notions: efficiency, equity, and simplicity. An ideal tax system would advance all three goals to some extent, while recognizing that sometimes the goals conflict. Similarly, a tax reform effort would acknowledge that all three goals are important but would manage trade-offs among them. An effi-

cient tax system would distort economic choices as little as possible while raising the appropriate amount of revenue. Typical characteristics of an efficient tax system are relatively low tax rates, broad bases for taxation, a portfolio of different types of taxes to limit reliance on any single revenue source, and an understanding of the incentives provided by the tax system so policymakers minimize the enticements for taxpayers to reduce their tax bill though otherwise uneconomic actions.

Equity, as applied in tax policy, has two components: horizontal and vertical. Horizontal equity means that taxpayers in similar economic circumstance are treated similarly. In income taxation, this means treating taxpayers with equal incomes equally. Strictly speaking, this would mean that the source of income would be disregarded in determining tax treatment and, ultimately, tax liability. Vertical equity means that tax liability should be distributed in accordance with the ability to pay taxes. That implies that those with larger incomes have a greater ability to pay taxes and therefore should shoulder a larger than proportionate share of the cost of pubic goods and services. This concept is associated with a progressive tax system, where the average tax rate paid (or average effective tax burden) goes up with a taxpayer's incomes. As a concept, vertical equity makes more sense when applied to the individual income tax or the entire tax system than when applied to the corporate income tax. The U.S. Federal individual income tax is progressive throughout almost the entire income distribution. The overall U.S. tax system is similarly progressive (*see* table 1).

Simplicity is the third principle of desirable tax policy. The Internal Revenue Service (IRS) regularly assesses the overall burden of the U.S. tax system by the number of hours required to understand one's tax obligations, keep appropriate records, file the necessary tax forms, and interact with the IRS after filing. Individual taxpayers spend around 2 billion hours a year complying with the individual income tax, and the cost to businesses is estimated to run to over $100 billion annually.

But beyond the hours and dollars, there is a sense among taxpayers and tax policy observers that the tax code is too complex for ordinary Americans to understand their tax obligations and comply with them. This sense of extreme complexity is evidenced by the robust tax preparation and tax software industries, as well as a belief among taxpayers that they are missing out on benefits being claimed by others. A lot of the existing complexity merely reflects the increasingly complex world in which we live. Individuals and businesses can enter into a nearly limitless number of possible economic transactions. These possibilities reflect economic and social complexity, globalization, and long-standing efforts at financial engineering. Congress, however, is complicit in this sense of growing complexity; over the past three decades, increasing amounts of social policy have been run through the tax code. While this can be an efficient way to deliver benefits to particular taxpayers, every one of these provisions carries with it eligibility rules and benefit calculations that can overwhelm taxpayers. This proliferation of tax expenditures itself fosters complexity.

But tax incentives should not be avoided simply because they lead to complexity. In some instances, overriding public policy considerations argue for deviating from one or more of the three major tax policy principles. For example, our economic system by itself may lead to an insufficient amount of activities with important spillover benefits (such as basic research) or to an excessive amount of some activities with negative spillover benefits (like tobacco or alcohol consumption). In these cases, specific provisions in the tax code (such as the research and experimentation tax credit or excise taxes on alcohol or tobacco purchases) can address under- or oversupply.

It is important to be aware of the trade-offs among tax policy principles. An optimal system will seek to balance out the contributions of each dimension and carefully weigh deviations. When Congress enacted the 1986 Tax Reform Act, it devoted much time, energy, and debate to considering how far to pursue each of these desirable traits in the legislation. Given three decades of incremental movement away from the 1986 agreement on all these policy goals, it is time to refocus on designing a tax system that meets them to the maximum extent possible.

Table 1. Average Effective Federal Tax Rates—All Tax Units

By Expanded Cash Income Percentile, 2018

Expanded Cash Income Percentile [1]	Tax Units		As a Percentage of Expanded Cash Income					
	Number (Thousands)	Percent of Total	Individual Income Tax [2]	Payroll Tax [3]	Corporate Income Tax	Estate Tax	Excise Tax	All Federal Tax [4]
Lowest Quintile	48,780.00	27.70	−4.71	6.36	0.66	–	1.80	4.10
Second Quintile	38,760.00	22.01	−1.13	7.50	0.98	–	1.32	8.67
Middle Quintile	34,290.00	19.47	3.78	7.89	1.18	–	0.97	13.82
Fourth Quintile	28,870.00	16.39	6.78	8.31	1.40	0.05	0.80	17.33
Top Quintile	24,300.00	13.80	16.05	6.02	2.62	0.22	0.57	25.48
All	176,100.00	100.00	10.01	6.93	1.95	0.13	0.80	19.82
Addendum								
80–90	12,490.00	7.09	9.18	8.65	1.58	*	0.71	20.15
90–95	6,020.00	3.42	11.35	7.95	1.88	0.13	0.65	21.95
95–99	4,650.00	2.64	15.96	6.09	2.41	0.17	0.58	25.23
Top 1 Percent	1,140.00	0.65	25.06	2.46	4.14	0.48	0.40	32.54
Top 0.1 Percent	120.00	0.07	25.80	1.38	5.45	0.43	0.33	33.39

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217–1).
* Less than 0.05; ** insufficient data; *** less than 5 in absolute value.

[1] The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2017 dollars): 20% $25,000; 40% $48,600; 60% $86,100; 80% $149,400; 90% $216,800, 95% $307,900; 99% $732,800; %99.9 $3,439,900. Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, *see http://www.taxpolicycenter.org/TaxModel/income.cfm*.

[2] After tax credits (including refundable portion of earned income and child tax credits).

[3] Includes both the employee and employer portion of Social Security and Medicare tax.

[4] Excludes customs duties.

LESSONS FROM PREVIOUS REFORM EFFORTS

Previous tax reform efforts have taught us three lessons:

1. Tax reform is technically difficult. It has many moving pieces. But the essence of reform is viewing these pieces as part of a whole legislative package that meets the over-arching goals of improving on the efficiency, equity, and simplicity dimensions while meeting the overall revenue target for the legislative effort.
2. Tax reform is even more difficult politically. The book *Showdown at Gucci Gulch* explains how the 1986 Tax Reform Act came together and notes how often-uneasy political alliances were formed to push the legislation to the next step. When undertaking true reform of the "broaden the tax base, lower the tax rate" variety, key constituencies often break along geographic or demographic or industry lines, not partisan ones.
3. This leads to a third lesson, which is that bipartisan tax reform may prove to be durable reform. And this committee's long tradition of bipartisan legislating bodes well for playing a leading role in developing a durable consensus on tax reform.

Those undertaking tax reform would do well to remember the hierarchy of responses to tax law changes developed by Joel Slemrod (a tax scholar at the University of Michigan). Slemrod notes that it is easier for taxpayers to shift the timing of transactions or their accounting treatment or to undertake paper transactions than to change their underlying economic behavior (Slemrod 1992).

An implication from Slemrod's hierarchy is that if tax rates are changed (or expected to be changed) on capital gains income, then investors will try to time the realization of gains (Slemrod 1992). We saw this happen in the pattern of capital gains realizations before and after the Tax Reform Act of 1986 and in the acceleration of bonuses and other compensation payments into the year before the 1993 tax law increased tax rates on upper-income Americans and the cap on Medicare payroll taxes was eliminated in 1994.

Similarly, when tax rates or tax provisions change, tax payers will reorganize entities or undertake financial engineering to maximize their after-tax well-being. Two examples are the shifts from C Corporations to S Corporations after the Tax Reform Act of 1986 reduced the top income tax rate on individuals below the rate on corporations, and the shifting of forms of borrowing once the Tax Reform Act of 1986 no longer allowed nonmortgage personal interest as a deductible expense.

A more recent example occurred at the State level when Kansas eliminated all income taxation on income from pass-through businesses in 2012. Over the next couple years, more than 100,000 pass-through businesses were created as Kansas taxpayers rearranged their finances to avoid paying the 5 percent State individual income tax. But the hoped-for increase in actual small business activity did not occur, which provides a cautionary tale.

As Slemrod notes, changes in real economic behavior—labor supply, investment, saving, business output—are least responsive to tax law changes. That doesn't mean that they cannot happen: some studies indicate a positive labor supply response by single mothers in response to changes in the earned income tax credit (Eissa and Liebman 1996). But it does suggest that some degree of caution is warranted when we hear claims about very large shifts in economic activity in response to tax law changes.

WHAT CAN BE DONE IN TAX REFORM

There are several potential areas where tax reform appears feasible and where large benefits can be gained from undertaking this difficult policy task. In theory, the business tax base can be broadened and the revenue generated used to reduce both the statutory corporate income tax rate and the tax burden on smaller pass-through businesses. For example, the Camp plan and the Obama administration plan presented pathways where the business tax system could be reformed and improved. The Obama administration plan was revenue neutral in the long-run and would have reduced the corporate tax rate from 35 percent to 28 percent.

One issue in need of attention is how to address the taxation of multinational firms in the context of a very globalized economy. The Obama administration plan addressed this issue by creating a hybrid system where U.S. firms would owe no tax on profits of foreign subsidiaries if they faced a tax rate above 19 percent. This

was described as a territorial system with a global minimum tax rate of 19 percent. Regardless, you would still need base erosion and mobile income restrictions (like current law subpart F) to prevent multinational firms from shifting profits from the United States to a lower-taxed foreign jurisdiction. But if the rate differential is lessened, the pressure to undertake these activities is also lessened.

As noted, it is possible in reforming business taxation to reduce taxes on smaller pass-through entities by expanding access to Section 179 expensing and cash accounting rules, and by providing more generous treatment of start-up and organizational expenses (especially important to new businesses). Since most pass-through businesses are small, these steps will benefit the clear majority of pass-through entities. But since total business activity in the pass-through sector is dominated by a relatively small percentage of firms, these larger firms (and their high-income owners) would likely experience a net tax increase from the base broadening related to business income.

Another area where there may be scope for tax reform that improves the tax system is in rationalizing the numerous incentives for similar activities in the tax code. Today, taxpayers are confronted with several incentives related to paying for higher education; these multiple options may confuse and burden taxpayers and may inhibit their take-up rate. A thorough review of tax provisions related to higher education (tax credits and deductions for tuition, student loan treatment, saving incentives, and income exclusions) could rationalize the tax treatment in this area and make the tax code more efficient, more equitable, and simpler.

A similar effort could prove useful in determining income and expenses for people who participate in the gig or sharing economy. These individuals tend to be classified as sole proprietors and face different tax rules than employees, but may not understand their tax obligations or have enough information from the platform company to comply with the tax law. Legislative steps to improve information sharing and to clarify rules for recognizing income and claiming appropriate expenses could help improve compliance among and reduce burden on millions of taxpayers.

SUMMARY

Congress has the opportunity to undertake significant reforms to the tax code. These reforms can improve the efficiency and equity of the tax system and reduce its complexity. But undertaking tax reform is hard work, and this committee has embarked on this effort, knowing the difficulties involved. However, these are targets of opportunity where bipartisan tax reform can and should occur. These include business tax reform and streamlining several aspects of the individual income tax. As the Congress and the administration identify specific opportunities for reform and develop potential solutions, these activities should be driven by data and evidence. The last major tax reform occurred over 30 years ago; it is almost surely time to take up the mantle of reform once again.

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QUESTIONS SUBMITTED FOR THE RECORD TO HON. MARK J. MAZUR

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

SIMPLIFICATION OF TAX SYSTEM—IMPACT ON INDIVIDUALS

Question. Individuals and small business owners spend billions of dollars complying with a labyrinth of tax rules every year.

What is the single most important thing Congress can do to help Americans save their hard earned time and money complying with our overly complex tax system?

Answer. Congress should recognize that there is a continuum of complexity faced by individual taxpayers that ranges from wage earners to self-employed individuals to businesses with one or a few employees to larger businesses. Similarly, there is another continuum of complexity along the dimension of capital income that ranges

from no capital income to limited amounts from traditional savings vehicles to investors with stocks, bonds, and mutual funds to investors with very complicated asset holdings that may involve tiered entities and complex financial instruments. Laws being considered should be evaluated through the lens of these complexities to ensure that the new statutes do not add to the underlying economic complexity. In addition, Congress should increase IRS funding so the agency can effectively interpret and administer the laws enacted by Congress.

GROWTH AND PROGRESSIVITY

Question. Many of us are very disturbed at the low rates of growth our economy has experienced for several years now.

So, one of the main drivers of tax reform is the desire to help achieve higher growth rates.

But we also hear a lot about progressivity and distribution.

So, my question is, to what extent, if at all, are the goal of growth and the goal of progressivity in tension with each other?

Answer. There is not necessarily a tension between the goals of improving economic growth and ensuring a fair distribution of tax burdens. Progressivity simply means having the share of tax burdens reflect taxpayers' ability to pay taxes, which generally is interpreted as having effective tax burdens increase with income. The United States tax system today exhibits a reasonable degree of progressivity, though it has been higher and lower at various times in the past. Revenue adequacy means that the tax system is raising sufficient revenue to meet the demands of the American public for goods and services. Adequate revenue can be raised at relatively low tax rates by paying attention to base-broadening when designing tax law changes. It must be noted that U.S. tax rates today are relatively low by historic standards for individuals and, to a lesser degree, corporations. Tax reform that broadens the tax base for both the individual and corporate income taxes could modestly lower tax rates, which would be a pro-growth step, without significantly reducing progressivity.

DISTORTION IN DEBT FINANCING VERSUS EQUITY FINANCING

Question. A number of you in your written testimonies addressed the differing tax treatment of debt and equity.

The corporate marginal effective tax rate on equity financing is about 35% while the corporate marginal effective tax rate on debt financing is negative. This creates a huge distortion in terms of financing.

Corporations are incentivized by the tax code to engage in debt financing rather than equity financing.

As part of tax reform, should we create greater parity in the tax treatment of debt financing and equity financing and if so, how should we accomplish that?

Answer. To start, it is helpful to recognize a tension inherent in an income tax, because interest paid is a cost of generating income and generally would be deductible under a classic income tax. So, providing a "haircut" on interest payments—making a portion nondeductible—to move in the direction of equal treatment for debt and equity financing, means stepping away from a pure income tax. However, a tax reform that provided a modest "haircut" on net interest payments and also moved depreciation schedules in the direction of economic depreciation (which reflects an asset's actual decline in market value) would help address negative effective marginal tax rates on debt-financed corporate investment.

WHAT IF THERE IS NO TAX REFORM?

Question. What are your views on the consequences of not achieving comprehensive tax reform this year or early next year?

Does the lack of tax reform this year mean continued anemic economic growth and stagnant wages?

Does the lack of tax reform this year mean continued pressure for U.S.-based multinational firms to relocate abroad or be acquired by foreign multinational companies?

Answer. The most important thing is to get tax reform right for the long term. Recall that the last time Congress enacted comprehensive tax reform was 1986, so

the life of a reform effort can be decades. Given a long-term perspective, it is better to take an adequate amount of time to seriously consider all aspects of a desirable tax reform and to build bipartisan support for that approach than to rush the process to meet an artificial deadline.

BENEFITS-RECEIVED TAXATION

Question. You discussed the importance of fairness in the tax system in your testimony. I agree with you as to the importance of fairness.

My question is, to what extent, if any, do you think that an appropriate measure of a tax's fairness is that the amount of the tax correlates with the benefit the taxpayer receives from the government?

Answer. When there are clear benefits associated with the provisions of a good or service, then it may be appropriate to have a "user pays" style of tax or fee structure. This works well for things like toll roads and could also be applied to providing funding for highways. But, generally, the provision of public goods and services that benefit all Americans should be financed with general revenues raised through broad-based taxes that are subject to "ability to pay" conditions.

INVERSIONS

Question. I am concerned about the wave of foreign acquisitions of American job-creating companies. I'm not just worried about existing U.S. jobs moving offshore, I'm worried about retaining the job prospects for future generations of Americans.

Does the relocation of a corporate headquarters impact local jobs in U.S. communities?

How can we help stem the tide of foreign acquisitions?

What type of tax rules would help American companies stay here and use the United States to not just serve U.S. customers but also to service foreign markets?

Answer. You are right to be concerned that relocation of corporate headquarters can have a disparate impact on the local community. The tax system should strive to not provide incentives for firms to relocate operations abroad to secure more favorable tax treatment. The reforms most likely to address this concern involve the rules affecting multinational firms. It should be a goal to reform the U.S. corporate income tax system in a long-run, revenue-neutral manner by broadening the tax base and lowering the maximum tax rate to a level comparable with our major trading partners. As part of this reform, it probably makes sense to institute a global minimum tax to lessen the tax reductions available by shifting income and perhaps operations to tax-haven countries. Congress could also consider repealing the "check the box" rule, which allows firms to more easily shift income among subsidiaries. Two sources for ideas about provisions along these lines are the Obama Administration Business Tax Reform plan released by the Treasury Department and the tax reform draft produced by Chairman Camp.

LAND TAX

Question. Dr. Peter Orszag recently asserted that "To fight inequality, tax land."[1] Is he correct that a tax on land would be distributionally progressive? That's not clear to me. If such a tax were to buy down tax rates on savings and investment, would such a tax be pro-growth?

Answer. The idea of taxing land is a long-standing concept in the area of public finance, going back a couple hundred years and most closely associated with Henry George. It is true that land is an immobile asset in fixed supply, so imposing a tax on land can have some efficiency effects. Given that land holdings closely track wealth, this can be a progressive tax as well. However, imposing such a tax would require assessments to be made of the value of all parcels of land, assuming there were no improvements on the property. This can be challenging in many jurisdictions. It is the case that many localities impose property taxes (usually on both the value of land and improvements), so there is a form of land taxation already in place. But it is not obvious to me that imposing a sizable tax on land is a desirable Federal policy.

[1] *See https://www.bloomberg.com/view/articles/2015-03-03/to-fight-inequality-tax-land.*

SUMMARY QUESTION

Question. Given your prior role as the top tax policy advisor at the Treasury Department, what big-picture/summary advice do you have for us as we continue down this path toward comprehensive tax reform?

Answer. I would provide four pieces of big-picture advice for the committee. First, ensure revenue adequacy for the short and long term. The fiscal imbalance we are experiencing today is likely to get worse as the Baby Boom generation fully reaches retirement age. Unmitigated and large Federal budget deficits are irresponsible and pass along fiscal problems to the next generation of Americans. Second, get the tax system right for the long term. Tax reform is a difficult process, and the results tend to last for years. So, proceeding methodically and obtaining durable and economically desirable results can deliver the type of reform that can have long-term payoffs. Third, be guided by principles, not politics. Undertaking tax reform is hard work technically, but the benefits to the Nation can be substantial if the main guiding force is concern for the public good. And finally, realize that bipartisan reform is more likely to lead to a better product and one that is more durable and long-lasting.

PREPARED STATEMENT OF HON. PAMELA F. OLSON, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2002–2004, DEPARTMENT OF THE TREASURY

Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, I appreciate the opportunity to appear this morning as the committee considers the prospects and challenges for enacting comprehensive tax reform legislation. I had the honor of serving as Treasury's Assistant Secretary for Tax Policy from 2002 to 2004, and am currently U.S. Deputy Tax Leader of PricewaterhouseCoopers LLP and leader of PwC's Washington National Tax Services practice. I am appearing on my own behalf and not on behalf of PwC or any client. The views I express are my own.

INTRODUCTION

Fixing our problems. As the chairman's statement announcing this hearing noted, Congress will face tough decisions in designing a simpler and fairer tax system that will better serve American individuals, families, and job creators.

The fact that tax reform is hard is obvious from the fact that it has been 31 years since Congress last enacted comprehensive tax reform. The fact that tax reform is hard is so familiar it has its own hashtag—#trih.

Meaningful comprehensive tax reform, as opposed to temporary tax cuts, will require careful consideration of competing interests and taking into account the country's pressing fiscal concerns. As demonstrated by last week's reports from the Social Security and Medicare trustees, measures to control rising spending levels must be carefully considered, but whatever spending decisions are made, to be sustainable, tax reform must produce sufficient revenues to cover the cost of what Congress agrees to spend. In addition, to be sustainable, a reformed tax system must attract and retain the business investment that is needed for the economy to grow. A system that leaves an unlevel playing field that continues to discourage capital investment and business formation in the country is an inherently unsustainable system.

The current political environment adds to the challenge of finding common ground on certain issues, but there is no body more capable of demonstrating how to work for the greater good on a bipartisan basis than this committee. Rather than focusing on the challenges, I want to focus on the rewards of tax reform if we succeed, and the risks to the country if we fail.

The potential rewards of a well-designed system—stronger economic growth, increased attractiveness to capital investment, faster job creation, rising wages—will lead to a more broadly-shared prosperity and make the effort well worth undertaking.

Conversely, as described in my testimony to this committee in 2015, the risks of inaction are great; moreover, they have increased during the intervening period. Over the last 30 years, the global economy has grown faster than the U.S. economy and other countries have changed their tax systems to increase their attractiveness as a location for investment. We must make tax policy choices that encourage U.S. investment and level the playing field for American companies and workers in the global marketplace.

PROSPECTS FOR COMPREHENSIVE TAX REFORM

There is widespread consensus that the United States needs to reform its tax system. Since the last comprehensive tax reform in 1986, the U.S. business tax system has not kept pace with the rest of the world as other countries have lowered their corporate tax rates, adopted territorial tax systems, and increased their reliance on consumption taxes, like value-added taxes, that are adjustable at the border.

While my testimony is focused primarily on business taxation, there is also a recognition of the need to make the tax code simpler for individuals and families seeking to save for education and retirement and less burdensome for entrepreneurs seeking to start and grow their own businesses.

As the members of this committee are well aware, revenue neutral tax reform produces vocal losers and largely silent winners. The base broadening that permits further rate reduction on a revenue-neutral basis is unpopular with those whose base is broadened, but the greater the rate reduction, the more palatable the base broadening will be, and the greater the benefit will be for the U.S. economy because taxes will have a reduced effect on decisions to work, save, and invest.

A competitive business tax system. The U.S. corporate tax rate, including State and local taxes, is the highest among advanced economies. The combined U.S. Federal and State statutory corporate tax rate currently is more than 15 points higher than the average of other Organisation for Economic Co-operation and Development (OECD) countries. Moreover, the rest of the developed world continues to lower their rates, as shown in the chart below highlighting changes in the global tax environment since the last time the United States enacted comprehensive tax reform legislation.

We have acquired our top rank and increased the distance between the United States and OECD average countries' corporate rates over a period of years because we have held our rate constant since 1993 (following a one point increase in the rate) while other countries have reduced their rates, a trend that may have slowed, but does not appear to have stopped nor certainly to have reversed direction. Nor does it seem likely to because, in contrast to the United States, other countries have increased their reliance on more stable sources of revenue that are more conducive to economic growth—in particular, consumption taxes like value-added taxes.

Taking into account the double taxation of corporate earnings that is part of the U.S. tax system, the United States remains on the leader board, but its ranking falls from first to third among OECD countries. Although the double tax was reduced through a reduction in the tax rate on dividends in 2003, the tax rate was increased in 2010 and again in 2013. Reducing the double tax, particularly using the corporate dividends paid deduction mechanism the committee staff has considered, could provide effective tax rate relief to U.S. corporations as part of a comprehensive tax reform package.

Bills introduced by members of this committee in prior Congresses, including bills introduced by Senator Wyden and Senator Cardin, would have significantly reduced the corporate tax rates in recognition of the need for a competitive business tax system. Senator Wyden's bills from 2010 and 2011 would have reduced the U.S. Federal corporate tax rate to 24 percent.

In the 7 years since Senator Wyden first proposed a 24-percent Federal corporate tax rate as part of comprehensive tax reform legislation, however, other countries have reduced their corporate tax rates further. Together with average State corporate income tax rates of about 6 percent, even a 24-percent Federal rate would leave the United States about 5 percentage points higher than the average rate for all other OECD nations. I strongly encourage you to find a way to achieve an even greater level of corporate rate reduction.

This committee's 2015 bipartisan business income tax working group, chaired by Senators Thune and Cardin, recognized the fact that the high U.S. corporate tax rate places American companies at a disadvantage in the global economy. The working group on international reform, chaired by Senators Portman and Schumer, reached a similar conclusion about the need for a lower rate to attract income from innovation.

The business income tax working group also examined how to achieve lower business income tax rates while maintaining revenue neutrality through various base broadening measures. Base broadening measures that close loopholes or eliminate provisions that distort investment decisions are worthy of consideration. Those should be distinguished from measures that broaden the base for the sake of a

broader base but that would have the likely effect of discouraging investment in the United States. The latter represent a false choice; they may appear to increase revenue but, because they discourage investment, the increase is illusory.

Opportunities for investment are increasingly globally and the competition for investment is fierce. Every decision to invest elsewhere makes more logical the next decision to invest elsewhere as the locus of activity shifts to other locations. The U.S. market remains globally attractive but that is despite our tax system, which impedes investment, not because of it. By failing to address the features of our tax system that discourage investment here, we will leave investments on the sideline. Moreover, if we broaden the base in ways that make U.S. investment less rewarding, we will lose investments to other jurisdictions.

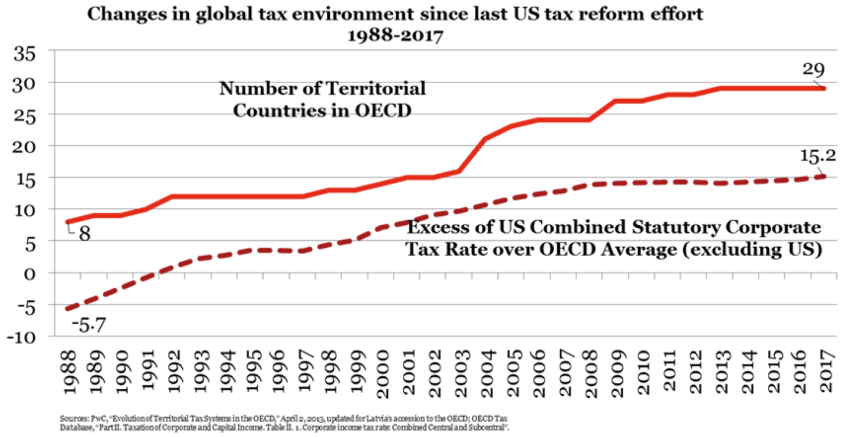
In summary, tax reform must produce a competitive tax rate for American companies to thrive in the ever-changing global marketplace. Our tax system should serve to facilitate, not impede, investment in the United States and to promote the efficient, effective, and successful operation of American businesses in today's global marketplace. A tax system that allows U.S. companies to compete more effectively will translate into increased domestic investment, jobs, and wages.

Modern international tax rules. In addition to cutting corporate tax rates, other countries have moved to modernize their international tax rules to reduce barriers to domestic investment. By contrast, the U.S. international tax system remains mired in a system of worldwide taxation established more than a century ago. The worldwide system may have served us well in the past. It no longer does. Its adverse effect is exacerbated by the disparity between the U.S. corporate tax rate and those of other countries.

The United States is the only OECD country to combine a high statutory rate with a worldwide tax system. No other developed country in the world subscribes to such a toxic brew—not one. Under U.S. tax rules, Federal corporate income tax on active foreign earnings generally is deferred until those earnings are repatriated to the United States. All but five of the other 34 OECD countries allow companies to repatriate foreign earnings to their home countries with little or no additional tax, as shown on the chart below.

Regardless of one's view on the taxation of foreign income, it is difficult to see the current system as anything other than the worst of all possible worlds. It produces little tax revenue; yet, because of the disparity between U.S. and foreign tax rates, creates a "lockout effect" discouraging U.S. companies' reinvestment of foreign earnings in the United States. A now retired tax director described it as "the 35-percent investment tax credit to leave my money offshore." The Joint Committee on Taxation (JCT) staff estimates that the amount of unrepatriated foreign earnings of U.S. companies increased to $2.6 trillion by the end of 2015, up from $1.7 trillion in 2010.

The Senate Finance Committee international tax reform working group chaired by Senators Portman and Schumer called for ending this lockout effect by adopting a dividend exemption system with "robust and appropriate base erosion rules." The international tax reform working group examined the need to make the United States a more hospitable environment for headquartering companies so as to remove incentives for "inversions" and also cited the global effort to address base erosion and profit shifting (BEPS) led by the OECD.



While the need to protect our tax base is self-evident, all anti-base erosion measures are not created equal, a point acknowledged in the international tax reform working group report. The effects of anti-base erosion rules must be carefully considered. The unintended consequences could be significant. The best anti-base erosion measure is a well-designed system, starting with a low rate that attracts investment and reduces the incentive to avoid the tax system. A well-designed system would also prevent base erosion by clearly defining the base subject to tax.

What has been called a foreign minimum tax is the anti-base erosion measure that has generated the most proposals. The concept has significant flaws. While it can be drafted to clearly define the base subject to tax, it does so as a secondary right to tax. As a secondary measure, it may discourage some tax planning, but it would do nothing to discourage other countries from trying to tax a greater share of U.S. companies' global profits. Indeed, it may even encourage them to do so. Other countries have been active in redefining their tax bases legislatively and administratively to the detriment of the U.S. Treasury since before the OECD commenced work on the BEPS project. A minimum tax does not address or even respond to those actions. Thus, it does nothing to give the United States a means of proactively responding to the threats to our tax base.

Because a minimum tax would only apply to U.S.-based companies, it would put U.S. companies at a competitive disadvantage relative to their global competitors. The United States can raise the tax paid by U.S.-based businesses on their foreign operations, though perhaps only temporarily, but it cannot raise the tax paid by foreign companies on their foreign operations. The effect of a minimum tax would likely be a continued disadvantage to U.S. ownership of businesses and assets and to U.S. headquartering. It would thus have the effect of discouraging U.S. investment. Stronger subpart F or controlled foreign corporation rules may well have the same effect. Because they apply only to the subsidiaries and activities of U.S.-based businesses, they put those businesses at a disadvantage in the global marketplace.

While reducing their corporate rates and adopting territorial systems, other countries have focused their attention on increasing revenues from activities within their borders. While this has involved some broadening of domestic income tax bases, the primary increase has come from increased reliance on consumption taxes, such as value-added or goods and services taxes. Because the tax base for a consumption tax is goods and services consumed within a country's borders, it provides a relatively fixed definition of the tax base and may have an anti-base erosion effect on the country's income tax base as well. The House Republican proposal for tax reform released in June of last year uses a similarly defined tax base. Unlike other countries, however, the House proposal is the effective repeal of the corporate income tax and replacement of it with a domestic consumption tax. In so doing, it necessarily excludes from the tax base all income attributable to goods and services consumed outside the United States.

Need for tax certainty. It is important to consider how global tax policy changes have heightened the level of uncertainty for U.S. companies competing globally since the 2015 Senate Finance Committee international tax reform working group com-

pleted its report. Global tax controversies continue to increase, creating ever higher levels of uncertainty for U.S. businesses competing around the world.

It is worth noting that a core part of the OECD's mandate is to reduce tax controversies and minimize the risk of double taxation. The OECD historically has consisted of a small group of relatively like-minded countries focused on helping member countries agree on uniform, consistent international tax rules, in order to minimize double taxation that could inhibit cross-border trade and investment. With more than 90 countries now participating in OECD's BEPS tax work, there are fundamental questions about the OECD's ability to achieve the consensus that will allow it to continue operating in coming years as a standard-setting body for international tax rules.

The BEPS project highlighted difficulties in achieving consensus with a large number of participating countries whose interests may not be aligned. Where such a consensus proved elusive, the final BEPS reports resorted to a "menu of options" approach, the antithesis of certainty. Without clarity from the United States, this puts U.S. companies at greater risk of double taxation at worst, and increased global tax controversies at best.

Although the U.S. Treasury was a very active participant in the BEPS discussion, the work began and proceeded without the direction from Congress that should have preceded the effort given what was at stake for the U.S. treasury. It is critical that Congress move forward with reform of our tax rules and provide the clarity needed for the continuing discussions of international tax rules.

The most dramatic example of the clash between outdated U.S. international tax rules and the actions of foreign authorities has been the European Commission's (EC) ongoing "State aid" investigations. The EC State aid investigations have been a matter of ongoing bipartisan concern by members of Congress. The U.S. business community appreciated the efforts in early 2016 of Chairman Hatch, Ranking Member Wyden, and Senators Portman and Schumer in writing to then-Treasury Secretary Jack Lew to express objections to the EC's actions in this arena.

Secretary Lew communicated U.S. concerns about the EC State aid investigations to European authorities. A 2016 Treasury white paper highlighted the potential for lost U.S. tax revenue, increased barriers to cross-border investment, and the undermining of the multilateral progress made toward reducing tax avoidance.

The EC's subsequent actions suggest that U.S. objections have had no discernable effect on the EC's approach to its State aid investigations and rulings that seek retroactive recoveries of EU taxes the EC asserts should have been paid. In the absence of U.S. action on tax reform, such controversies appear likely to continue as foreign tax authorities seek to claim a portion of the foreign earnings of U.S. companies that remain unrepatriated or "locked-out" of the United States.

Changing views on taxation. A key challenge facing U.S. tax reform efforts is how best to raise needed revenue in a manner that is both efficient and conducive to the economic growth that will produce jobs and rising wages. Over the course of recent decades, foreign governments in both the developed and the developing world have adopted policies that reflect a changing view of business income taxes.

This changing view reflects a recognition that the share of GDP attributable to intangible assets, such as patents, knowhow, and copyrights, has increased substantially. Unlike property, plant, and equipment, intangible assets are highly mobile and more likely to be exploitable on a global basis, increasing their value. This shift has been accompanied by the reorganization of economic activity around global value chains and strategic networks that flow across national borders.

The rise in the value of intangibles and the interconnected nature of the global economy has led to a recognition that it is more difficult to measure and tax income earned within a country. To fund their governments, other countries have addressed this issue by relying more heavily on consumption-based taxes, such as value-added or goods and services taxes, that are applied to a tax base that is more easily measured and less mobile. Consumption taxes have the added benefit of being more conducive to economic growth.

At the same time, many foreign governments have recognized the global mobility of capital and intangible assets and have come to view changes to business income tax rates as a competitive tool that can be used to attract investment. By reducing statutory business income tax rates, adding incentives for research and development, innovation, and knowledge creation, and adopting territorial systems that limit the income tax to activities within their own borders, governments have sought

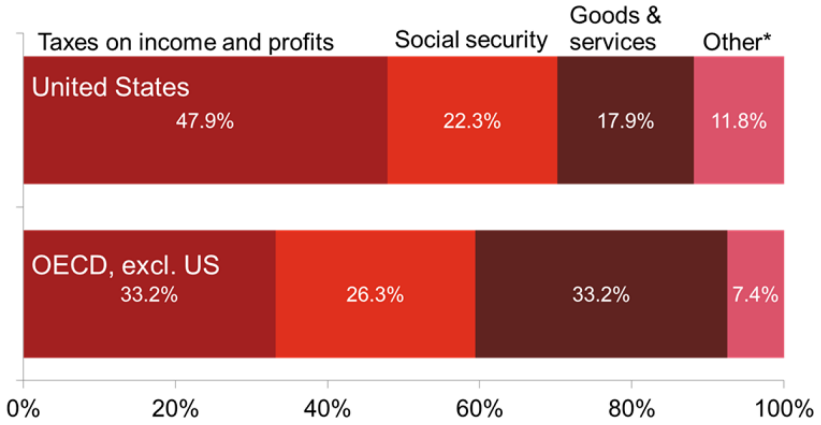
to attract capital that will yield jobs, particularly high-skilled jobs for scientists, engineers, and managers.

These trends reflect a practical recognition of the challenge of taxing highly mobile intangibles and capital and also the fact that economists across the political spectrum have concluded that consumption-based taxes are a more efficient way of raising revenue in an open economy than the corporate income tax.

The approach taken by other countries is reflected in a bill introduced by Senator Cardin during the last Congress. It included a progressive consumption tax that would reduce the U.S. corporate tax rate to 17 percent and exempt most individual taxpayers from income taxation by lowering rates and providing a family allowance of $100,000 for joint filers and $50,000 for single filers. The 10-percent credit-invoice, border-adjustable value-added tax included in Senator Cardin's bill contained an exemption from collecting the tax for small businesses with under $100,000 in annual receipts.

The extent to which the United States is out of sync with the competitive and pro-growth tax policies of other nations can be seen in the chart below, which shows the Federal Government's primary reliance on income taxes in contrast to most of the world's major economies, which rely to a more significant degree on consumption taxes. Other OECD countries on average rely equally on income and profits taxes and goods and services taxes while the United States relies 2.7 times more heavily on income and profits taxes than goods and services taxes.

While the addition of an alternative tax base may be beyond the reach of the current tax reform effort, there are practical limits to generating sufficient revenues through our existing income and payroll tax bases to meet the obligations for Social Security, Medicare, and other Federal programs without incurring unsustainably high levels of Federal debt or imposing levels of spending reductions that appear politically unlikely. An alternative tax base, coupled with lower rates on existing tax bases, would better align our tax system with the tax systems of every other developed country.



* Other is primarily property taxes.
Source: OECD Revenue Statistics, 2014.

In conclusion, I believe that Congress must move swiftly to reform the tax code. To be sure, there are challenges to doing so, but the opportunities for a stronger economy, job and wage growth, and more broadly-shared prosperity will reward the effort. Tax reform is also essential to respond to the risk inherent today in other countries' continued updating of their tax systems to be more internationally competitive.

In a rapidly changing world, I do not think our country can afford to look at tax reform as a once-in-a-generation exercise. I would challenge the Congress to look at tax reform as an exercise regularly undertaken. Much as the 2015 PATH Act served as a stepping stone to the current tax reform effort by making the research credit and other significant provisions permanent, Congress should not view the meaning-

ful tax reform achieved by this Congress as the final word for another generation. It should be the responsibility of each succeeding Congress to examine the tax system and to build on the reforms enacted by this Congress. The United States first must regain, but then must maintain, a tax code that promotes economic growth and improves the economic well-being of all Americans.

QUESTIONS SUBMITTED FOR THE RECORD TO HON. PAMELA F. OLSON

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

SIMPLIFICATION OF TAX SYSTEM—IMPACT ON INDIVIDUALS

Question. Individuals and small business owners spend billions of dollars complying with a labyrinth of tax rules every year.

What is the single most important thing Congress can do to help Americans save their hard-earned time and money complying with our overly complex tax system?

Answer. Replacing itemized deductions with an expanded standard deduction, and combining, eliminating, or replacing the wide variety of credits available for education, saving, health care, etc., with lower rates would dramatically simplify the tax system for a large percentage of the population.

HIGH IMPORTANCE FOR BUSINESS

Question. Each of you interacts with and advises small and large businesses on a daily basis.

What are these businesses telling you is most important to them as part of tax reform?

What are the major themes you're hearing from large and small businesses alike?

Answer. Generally, businesses that are globally engaged or face global competition believe lower tax rates and a territorial system like the systems adopted by much of the developed world are the most important parts of tax reform. Businesses that are purely domestic believe tax reform should deliver lower tax rates and a simpler system that requires less paperwork and recordkeeping to comply.

DISTORTION IN DEBT FINANCING VERSUS EQUITY FINANCING

Question. A number of you in your written testimonies addressed the differing tax treatment of debt and equity.

The corporate marginal effective tax rate on equity financing is about 35% while the corporate marginal effective tax rate on debt financing is negative. This creates a huge distortion in terms of financing.

Corporations are incentivized by the tax code to engage in debt financing rather than equity financing.

As part of tax reform, should we create greater parity in the tax treatment of debt financing and equity financing and if so, how should we accomplish that?

Answer. Greater parity is desirable and could be achieved through integration of the corporate and individual tax systems through a dividends paid deduction or similar mechanism.

TWENTY-FOUR PERCENT CORPORATE TAX RATE?

Question. Ms. Olson, in your testimony, you state that we need to get the corporate rate below 24%. I agree.

But is it better to get the rate to 24%, if that's the best we can do, or better to keep working for something better, and reject a deal getting us to a 24% rate?

Answer. The perfect shouldn't be the enemy of the good. While I believe Congress should find a way to achieve a more competitive corporate tax rate than 24%, Congress should make as much progress as possible towards a more competitive tax system, and plan to return to it again. As I stated in my testimony, I don't believe tax reform can continue as a once-in-a-generation event. The rapidity of dramatic changes in the economy means that we should not expect that Congress can enact a system today that won't require further changes for another generation. The dramatic economic changes have been met by swift and equally dramatic changes to

tax systems by much of the rest of the developed world. It is important for the United States to keep pace.

WHAT IF THERE IS NO TAX REFORM?

Question. What are your views on the consequences of not achieving comprehensive tax reform this year or early next year?

Does the lack of tax reform this year mean continued anemic economic growth and stagnant wages?

Does the lack of tax reform this year mean continued pressure for U.S.-based multinational firms to relocate abroad or be acquired by foreign multinational companies?

Answer. By failing to respond to other governments' tax changes that have made their countries more attractive places for investment, the United States has been running a multi-year experiment on the economy, and the experiment has failed.

Delay in enacting tax reform is likely to retard investment in the United States with a corresponding negative effect on economic growth, including wage growth.

The United States' current tax system puts a discount on the value of business assets in the hands of a U.S. company relative to that of a foreign acquirer. If the United States were to fail to enact a more competitive tax system, there would be renewed pressure on American companies because they would be more globally competitive if owned by a foreign headquartered company.

INVERSIONS

Question. I am concerned about the wave of foreign acquisitions of American job-creating companies. I'm not just worried about existing U.S. jobs moving offshore, I'm worried about retaining the job prospects for future generations of Americans.

Does the relocation of a corporate headquarters impact local jobs in U.S. communities?

How can we help stem the tide of foreign acquisitions?

What type of tax rules would help American companies stay here and use the United States to not just serve U.S. customers but also to service foreign markets?

Answer. Recent research finds that a move in corporate headquarters resulting from an inversion leads to a smaller share of employees and investment in the United States than for non-inverting companies. This move in operations and activity abroad has a negative effect on the communities from which the operations are moved as the impact ripples through the community. To stem the tide of foreign acquisitions, the United States Congress should act to create a level playing field so that headquartering a company in the United States and investing in the United States do not carry a tax disadvantage. Reducing the corporate tax rate to an internationally competitive level, adopting a territorial tax system, and increasing reliance on consumption taxes would make the United States a more attractive location for operations serving both U.S. and foreign markets and eliminate the tax benefit of a foreign acquisition.

LAND TAX

Question. Dr. Peter Orszag recently asserted that "To fight inequality, tax land."[1] Is he correct that a tax on land would be distributionally progressive? That's not clear to me. If such a tax were to buy down tax rates on savings and investment, would such a tax be pro-growth?

Answer. I am uncertain whether a tax on land would be distributionally progressive. Most state and local governments levy annual taxes on real property so (at least in some states) land, as a component of total real property value, is taxed and produces significant revenue to fund state and local government. In determining the distributional effect, the use to which the revenue is put should also be considered.

[1] *See https://www.bloomberg.com/view/articles/2015-03-03/to-fight-inequality-tax-land.*

SUMMARY QUESTION

Question. Given your prior role as the top tax policy advisor at the Treasury Department, what big-picture/summary advice do you have for us as we continue down this path toward comprehensive tax reform?

Answer. Capital is mobile. To be sustainable, tax reform must produce a globally competitive system or the United States will lose investment and corporate headquarters to other countries. That means a lower corporate rate and a territorial system like the rest of the developed world.

Tax reform should yield a system that is simpler so that individuals and small businesses, in particular, find it easier to comply and spend less of their time and resources complying with the tax laws. A simpler system would be a more transparent system that would increase taxpayers' confidence that the system is fair.

Congress should not treat tax reform as a one-and-done exercise, but rather should commit to reexamining the tax system regularly to ensure it is competitive and fit for purpose.

Congress should examine the mix of taxes on which we rely. In particular, consumption taxes are widely viewed as being more conducive to economic growth but the United States relies very little (relative to other countries) on consumption taxes, especially at the Federal level. Adopting a consumption tax at the Federal level could help meet our revenue needs in the coming years with less harm to economic growth.

PREPARED STATEMENT OF HON. ERIC SOLOMON,[1] FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2006–2009, DEPARTMENT OF THE TREASURY

Mr. Chairman, Senator Wyden, and distinguished members of the committee, thank you for the opportunity to testify today on tax reform. I had the privilege to testify before this committee in March 2011, with other former Assistant Secretaries for Tax Policy. We testified on how changes since the Tax Reform Act of 1986 have affected the tax code. That hearing was one of a series of hearings held by Congress to advance the process of reforming our tax system.

For many years, policymakers have expressed a desire to reform the Internal Revenue Code. Much has changed since the last major overhaul in the Tax Reform Act of 1986. All of us recognize that updating the code is a necessity. We hope we are at a climax in this effort, and that in the coming months we will see the enactment of significant reform.

As I stated in my 2011 testimony, the primary purpose of the Federal tax system is to collect the revenues needed to fund the government. We would all agree that goals of an optimal tax system would include promoting economic growth, minimizing distortions, and supporting the competitive position of American businesses around the globe. Another goal is that our tax system should be as simple as possible, fair and stable. It should also be administrable for individual and business taxpayers as well as for the Internal Revenue Service. Our current tax system is suboptimal in achieving these goals.

We live in a constantly changing world. Economic, social, and political developments, including accelerating advancements in technology, are changing our Nation and its role in world affairs and the global economy. As the global economy evolves, we need to re-evaluate our tax laws to ensure they are responsive to current and anticipated domestic and global conditions. We must also recognize that our tax system does not operate in a vacuum—it is one of many tax systems around the world, and as other countries revise their tax systems, we must respond as necessary to ensure that our tax system is in the best possible position to facilitate outbound and inbound investment and maximize the welfare of the American people.

Numerous tax bills have been enacted since 1986. The Internal Revenue Code is a patchwork of provisions serving a wide variety of purposes. As the code grows, and the regulatory and administrative guidance interpreting and implementing the code also grows, our enormously complex tax system becomes even harder for taxpayers to understand and for the IRS to administer.

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[1] I was Assistant Secretary for Tax Policy at the Treasury Department from 2006 to 2009. I have been asked to testify in my individual capacity. My written and oral remarks are my own and do not necessarily represent the views of Ernst and Young LLP or its clients.

The debate about tax reform has been ongoing for over a decade. Extensive groundwork has been laid by the work of policymakers, academics, taxpayers and practitioners. It is now essential to take the next step and enact tax reform that, among other things, reduces tax rates, eliminates various preferences, modernizes the international tax system, and helps American workers and families. If possible, the reforms should be permanent. In addition, tax reform should be distributionally neutral, so the relative burden of income taxation does not shift.

All of this should be achieved in a fiscally responsible manner. Everyone is aware of the long-term fiscal challenges our Nation faces as spending, especially mandatory spending, continues to increase. We need to reform our tax system in a manner that does not disadvantage us in addressing our long-term budget imbalances.

Despite the challenges in designing a new system, we have an opportunity we do not want to miss. There will necessarily be compromises along the way, but the most important objective is to enact tax reform that moves the tax law in the proper direction. As quickly as possible, it is important to enact legislation that will end uncertainty that could deter business and investment activity. Tax reform will provide benefits to American businesses, workers and families. There is a window of opportunity now, and it is important to act before that window shuts.

WHY TAX REFORM?

The reasons for tax reform are well-known. Some of the reasons for tax reform include:

(1) *An evolving business and global landscape.* The U.S. economy is very different than it was at the time of the Tax Reform Act of 1986, the last major overhaul of the Internal Revenue Code. The world economy and the U.S. role in that economy is vastly different than it was in 1962, when the basic structure of our international tax system was enacted. The U.S. economy is increasingly integrated and interdependent with the economies of other nations. Both capital and labor have become increasingly mobile. Traditional manufacturing has declined in relative size, while technology, services, financial innovation, and intangible assets have become more important. It is necessary to reform the code in light of these significant changes.

(2) *Increasing global competitive pressures.* While the code has grown in size and complexity, its structure generally has remained unchanged over the past several decades. In contrast, other countries have responded to increased global competition, lowering their corporate tax rates and shifting to territorial tax systems. Taxes are one factor businesses consider in deciding where to locate their activities. Businesses take into account other factors as well, such as labor costs and political and financial stability. As its competitive edge in other factors narrows, the United States must adapt its tax system to meet global competition.

(3) *The inclusion of many special provisions in the code.* The Internal Revenue Code does much more than raise revenue necessary to fund the Federal Government. The Code contains many provisions for individuals and businesses that address social and economic policy issues. As a result, the code has grown enormously and is increasingly complex. Because of special provisions, the code taxes some taxpayers at high effective rates and others at much lower effective rates. It is necessary to reform the code to simplify it and remove distortions. Simplification would make it easier for individuals and businesses to comply with their tax obligations and would make it easier for the IRS to administer the law. A simpler Code would improve taxpayer perceptions regarding the fairness of the tax system.

(4) *Inadequacies of the U.S. international tax system.* The United States has a unique international tax system that provides for deferral of tax on active foreign earnings until they are repatriated to the United States. Most other countries have adopted a territorial tax system, which generally exempts from tax earnings from foreign operations. The high U.S. corporate tax rate and repatriation tax encourage U.S. companies to move activities offshore and keep the earnings offshore (the so-called "lockout effect"). The U.S. international tax system also creates an incentive for U.S. companies to use transfer pricing among affiliates to shift income to lower-tax jurisdictions. Furthermore, it creates an incentive for U.S. companies to engage in inversions. It is necessary to reform the code to address these international tax problems.

(5) *Incentives to use debt financing.* The current U.S. tax system favors the use of debt financing rather than equity financing. Business interest expense is deductible, whereas dividend payments are not. The deduction for interest creates an incentive for businesses to borrow more than they otherwise would, increasing the risk of financial failure. The tax law should be made more neutral in its treatment of debt and equity.

(6) *The need for stronger economic growth.* It is important to increase the rate of economic growth in the United States. Economists agree that faster write-off of capital investments promotes economic growth by encouraging such investments. Lower tax rates will also promote growth. Higher economic growth will help U.S. businesses, workers, and families.

KEY ISSUES TO ADDRESS

In designing a tax reform package, there are a number of important issues that need to be addressed. The following is a discussion of 10 issues. Many of the issues are interrelated and decisions about an issue will affect decision-making about other issues.

1. Should tax reform be revenue-neutral? What baseline should be used to measure this? What scoring method?

Congress will need to decide whether to make tax reform revenue-neutral. In making this decision, Congress must select a baseline and a scoring method.

There are two options for a baseline, a current law baseline or a current policy baseline. A current law baseline assumes that current law will continue to apply, including future changes in the law already enacted, such as expiring provisions. A current policy baseline assumes that various expiring provisions will be extended.

Congress must decide whether to use conventional or dynamic scoring. Conventional scoring assumes a fixed gross national product (GNP). Dynamic scoring takes into account the effect of significant tax changes on GNP and the resulting effect on tax revenues.

If the reconciliation process is used for tax reform, no title of the bill can lose revenue outside the budget window; otherwise the title will be subject to a point of order requiring 60 votes. If the point of order is not overcome, the title will be stricken from the bill. To avoid this, provisions can be designed to sunset at the end of the budget window and not lose revenue outside the budget window. Congress would need to select a budget window for this purpose—10 years or perhaps longer.

If the point of order is overcome by obtaining 60 votes or if the reconciliation bill is revenue-neutral outside the budget window, it can be permanent. Permanence provides tax certainty for business and investment decision-making. In addition, a revenue-neutral bill has less potential to worsen our country's long-term fiscal imbalance. However, maintaining revenue neutrality would prevent tax reform from providing greater benefits, such as a greater reduction in the U.S. corporate tax rate to make it more competitive with tax rates in other countries.

In addition to revenue neutrality, distributional neutrality is an important consideration in tax reform. Distributional neutrality ensures that no particular income class receives an advantage over another.

2. How much can tax rates be lowered?

The resolution of the question of how much tax rates can be lowered depends in large measure on whether tax reform would be revenue-neutral, what deductions, credits, and other provisions would be eliminated for individuals and businesses, and what revenue raisers would be included. It is anticipated that a broader income tax base would remove distortions, resulting in a more efficient system fostering improved economic growth.

How much the U.S. corporate income tax rate can be lowered is a critical question for business tax reform. Today the United States has one of the highest statutory corporate income tax rates in the world (35% plus State corporate taxes). Over the years, other countries have lowered their corporate tax rates significantly below the U.S. rate. This disparity in rates encourages U.S. companies to move activities overseas, and the U.S. deferral system of international taxation that imposes a tax on repatriated earnings encourages U.S. companies to keep their active foreign earnings offshore. The disparity in tax rates also encourages U.S. companies to engage in inversions to reduce their U.S. tax burden.

A substantial reduction in the U.S. corporate tax rate would lessen the incentives described above. The greater the reduction, the more those incentives would be diminished.

3. What deductions, credits, and other provisions should be eliminated?

Selecting individual and business deductions, credits, and other provisions to eliminate will be a difficult process. Over the years many provisions have been added to the code to address social or economic issues. The deduction for home mortgage interest was enacted to encourage home ownership. The charitable deduction was enacted to encourage charitable giving. Many special provisions, such as the research credit, encourage activity that has favorable spillover benefits that benefit more than the taxpayer engaging in the activity.

4. Should tax reform include a territorial system? With base erosion provisions?

Most other countries have adopted a territorial tax system, which generally exempts from tax the active earnings from foreign operations. As indicated above, the United States has a unique international tax system that permits deferral of tax on active foreign earnings until they are repatriated to the United States. The repatriation tax puts a U.S. multinational at a disadvantage compared to a multinational company from a territorial country with respect to operations in a third country. The multinational from a territorial country is not subject to a repatriation tax on income earned in the third country.

If Congress enacts a territorial tax system where active foreign earnings are generally not subject to U.S. tax even when repatriated to the United States, there will be continuing incentives to shift activities from the United States to low-tax jurisdictions. Commentators generally agree that base erosion provisions must be included in tax reform to combat this shifting.

Several possible base erosion provisions have been suggested, including for example a proposal to tax "foreign-based company intangible income" in Chairman Camp's Tax Reform Act of 2014, the Obama administration's proposal for a minimum tax on foreign income in the 2012 Framework for Business Tax Reform, and the border adjustments proposed in the House Republican Blueprint.

It is anticipated that international tax reform would include a deemed repatriation provision that would impose a tax on unrepatriated foreign earnings. There is more than $2 trillion of unrepatriated foreign earnings held by U.S. multinationals. The tax rate on the deemed repatriated amounts might vary depending on whether the offshore earnings are invested in liquid assets or invested in other assets such as plant or equipment. Issues include how the amount of unrepatriated foreign earnings would be calculated, at what point in time they would be calculated, and how the earnings would be allocated between liquid assets and other assets.

5. Should tax reform include border adjustments?

Using a cash-flow based approach for businesses applied on a destination basis, the House Republican Blueprint would exempt from U.S. tax products, services, and intangibles that are exported outside the United States regardless of where they are produced. Products, services and intangibles that are imported into the United States would be subject to U.S. tax regardless of where they are produced. Stated another way, income from exports would be exempt from tax (but associated deductions would be permitted), whereas deductions for imports would be denied (but associated income would be taxable).

Border adjustments would have the advantage of reducing incentives to move or locate operations outside the United States, because products exported from the United States would be exempt from U.S. tax just like products produced outside the United States. Border adjustments would also raise a substantial amount of revenue, because the United States is a net importer.

U.S. companies that import a significant portion of their inputs fear that their tax burden would increase substantially as a result of border adjustments (the same amount of income with substantially fewer deductions). Some economists assert that, because of correlative adjustments in exchange rates (or price levels or wages), border adjustments that are symmetrical as to exports and imports would not harm importers and would not result in a change in the levels of U.S. exports and imports or the balance of trade.

Under this reasoning, denial of deductions for imports would raise the U.S. cost of imports and consequently reduce U.S. demand for them. This would result in an increase in value of the dollar as compared to other currencies (because of weaker

U.S. demand for imports), which would reduce the cost of imports, mitigating the reduction in U.S. demand for them. Similarly, the exclusion of income from exports would lower the U.S. cost of exports and increase foreign demand for them. This would result in an increase in the value of the dollar as compared to the currencies (because of stronger foreign demand for U.S. exports), which would make U.S. exports more expensive for foreigners, mitigating the increase in foreign demand. As a result of the currency adjustments, for importers the lower cost of imports would offset the additional tax from the denial of deductions for imports, and for exporters the reduced tax from the exclusion of income from exports would be offset by reduced revenue from exports.

There has been considerable debate about how these adjustments would operate in actual practice, including how quickly the relative value of the U.S. dollar would adjust, and whether the effect of the anticipated increase in the relative value of the U.S. dollar on the cost of imports would completely offset the tax increase for importers.

Furthermore, there are various uncertainties in the border adjustments as outlined in the House Republican Blueprint. For example, it might be relatively clear how to identify export income or import expenses related to tangible goods, but it is not as clear for income and expenses from intangibles and services. Also, special rules would be required for financial institutions.

Moreover, it is not clear whether the border adjustments as outlined in the House Republican Blueprint would comply with World Trade Organization rules. Irrespective of WTO issues, it is uncertain how other countries might respond if the United States were to enact such border adjustments. It is also uncertain how U.S. bilateral tax treaties would apply to the border adjustments and whether the border adjustments would violate treaty obligations.

Finally, an increase in the relative value of the U.S. dollar would increase the value of U.S. assets held by foreigners and decrease the value of foreign assets held by U.S. persons.

6. Should tax reform include limitations on the deductibility of interest expenses?

As previously discussed, the current tax system favors the use of debt financing rather than equity financing because business interest expense is deductible, whereas dividend payments are not.

Over the years, there has been considerable discussion of corporate integration as a means to eliminate the distortions caused by the double tax imposed by the U.S. corporate tax system (tax on earnings at the corporate level and a second tax on shareholders with respect to dividends and capital gains). The distortions include: (1) the incentive to use pass-through businesses (partnerships, limited liability companies, or S corporations) or sole proprietorships rather than C corporations; (2) the incentive for corporations to use debt financing rather than equity financing; (3) the incentive for corporations to retain earnings and not pay dividends; and (4) the incentive for corporations to pay out earnings in ways other than dividends (such as the payment of deductible compensation, interest, rent, or royalties).

Corporate integration could equalize the treatment of debt and equity financing for tax purposes (for example by making dividend payments deductible like interest payments) or make their tax treatment more symmetrical (for example by providing a dividend exclusion for shareholders, so that dividends would be nondeductible and not includible in income, whereas interest payments would be deductible and includible in income). In 1992 the Treasury Department issued a study about various options for corporate integration. More recently, in December 2014 the Republican staff of the Senate Finance Committee released "Comprehensive Tax Reform for 2015 and Beyond," which includes an extensive discussion about corporate integration.

There are a number of potential options for limiting deductions for business interest expenses, including for example: (1) denying a deduction for net interest expense, as proposed in the House Republican Blueprint; (2) disallowing net interest expense to the extent it exceeds a formulaic amount (for example, in excess of a certain percentage of income); or (3) disallowing net interest expense to the extent the ratio of U.S. interest expense to U.S. income exceeds the worldwide ratio for the company's corporate group, as proposed in Chairman Camp's Tax Reform Act of 2014. If tax reform includes a provision limiting interest expense, special rules would be necessary for financial institutions, such as banks.

7. How should tax reform deal with cost recovery?

The House Republican Blueprint proposes immediate cost recovery for investments in both tangible property (such as equipment and buildings) and intangible assets (such as intellectual property). It would not apply to land.

Economists believe that expensing would encourage business investment and result in significant economic growth. However, expensing cannot be combined with interest deductions—otherwise there would be a negative tax rate on leveraged capital investments.

There are various taxpayers who are not enthusiastic about expensing and would prefer retention of a deduction for business interest expenses. For example, purchasers of land, which would not qualify for expensing, would like to continue to deduct interest expenses on the debt used to acquire the land. In addition, small businesses already have expensing under section 179 and would prefer not to lose a deduction for interest expenses. Also, many businesses are satisfied with 50% bonus deprecation.

8. How should tax reform deal with pass-through entities?

The treatment of income earned by pass-through entities, such as partnerships, limited liability companies, and S corporations, raises challenging issues. It is expected that income earned by pass-through entities would be taxed at a lower rate than compensation income. The reason for this proposal is that the tax rate for corporate income would be reduced, so therefore similar business income earned by pass-through entities should also benefit from a reduced tax rate.

It is anticipated that the benefit of the lower rate would not be available for income earned by a pass-through entity related to an owner's performance of services. The basis for this exclusion is the concern that the tax that would otherwise be owed on compensation income should still apply if business is conducted through a pass-through entity.

Exactly how this system for pass-through entities would operate is not clear. Presumably income earned by a pass-through entity would be divided into different parts (such as business or investment income). Each owner's distributive share of business income would be taxed at the lower rate, except that some portion (or all) of this distributive share would be taxed as compensation if the partner materially participates in the entity's operations. An owner's compensation portion taxable at higher rates could be calculated in one of several ways, such as: (1) an amount equal to "reasonable compensation," (2) the entire distributive share reduced by a return on capital contributed by the owner to the entity, or (3) a fixed portion of the distributive share (say 70%).

Similar issues are also presented by earnings of sole proprietorships. Because there is no legal separation between a sole proprietorship and its owner, rules would need to separate the owner's business activity from other activity and further separate income taxable as compensation from income taxable at the lower rate.

9. What transition rules should be included?

Consideration would need to be given to transition issues. For example, if full expensing is enacted, how would property placed in service before enactment be treated? Would continuing depreciation deductions be permitted for property placed in service before enactment? Would deductions be phased out over time?

If limitations on deductibility of interest expenses are enacted, how would debt incurred before enactment be treated? Would continuing interest deductions be permitted? Would deductions be phased out over time?

Transition rules would soften the impact of new rules on pre-enactment activity. However, transition rules could delay or lessen the anticipated benefits of tax reform.

10. How would tax reform restructure the Internal Revenue Service?

The House Republican Blueprint calls for remaking the IRS into a streamlined organization dedicated to delivering world-class customer service. Our tax system relies on voluntary compliance. Voluntary compliance depends in large measure on the belief of the American people that the tax law is equitable and is administered fairly. Any restructuring of the IRS should make sure the agency has the capability, both in services and enforcement, to collect the revenues called for by law in a fair, consistent and efficient manner using modern information technology.

CONCLUSION

The list of issues that must be addressed may appear to be daunting. Nevertheless, there is a pressing need to make our tax system better. We need to take advantage of our window of opportunity before it shuts.

In March 2011, I closed my testimony before this committee by referring to the story in Greek mythology about the fifth labor of Hercules. His task was to clean the Augean stables, which had not been cleaned in 30 years. More than 30 years have passed since the Tax Reform Act of 1986. We need to complete the Herculean task of reforming the Internal Revenue Code.

QUESTIONS SUBMITTED FOR THE RECORD TO HON. ERIC SOLOMON

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

SIMPLIFICATION OF TAX SYSTEM—IMPACT ON INDIVIDUALS

Question. This question is for each witness: individuals and small business owners spend billions of dollars complying with a labyrinth of tax rules every year.

What is the single most important thing Congress can do to help Americans save their hard earned time and money complying with our overly complex tax system?

Answer. The most important thing Congress can do to help individuals and small business owners comply with the labyrinth of tax rules is to simplify the calculation and reporting of tax liability. Our tax system would be improved if taxpayers could fill out and file their own tax returns. By doing so, taxpayers would save time and money and they would better understand and appreciate their civic obligation.

HIGH IMPORTANCE FOR BUSINESS

Question. Each of you interacts with and advises small and large businesses on a daily basis.

What are these businesses telling you is most important to them as part of tax reform?

What are the major themes you're hearing from large and small businesses alike?

Answer. Businesses have four primary concerns: (1) the need to revisit our antiquated tax code; (2) the desire for certainty; (3) a lower business tax rate; and (4) for businesses that operate across borders, an improved international tax system.

(1) *The need to revisit our antiquated tax code.* We live in a constantly changing world. Economic, social and political developments, including accelerating advancements in technology, are changing our nation and its role in world affairs. We need to re-evaluate our tax laws to ensure they are responsive to current and anticipated conditions. The last major reform of the Internal Revenue Code occurred in 1986, when the United States was very different than it is now. We need to update our tax system to ensure that it is in the best possible position to facilitate investment and maximize the welfare of the American people.

(2) *The desire for certainty.* Businesses need certainty in order to make their plans for the future. They need certainty to compute the projected return on their investments. They need to know their expected costs, including their anticipated tax liability. For this reason, businesses desire a stable tax code with permanent provisions. In addition, tax reform has been discussed and debated for over a decade, and businesses are uncertain if and when tax reform will occur. Businesses would benefit if tax reform is enacted as soon as possible.

(3) *A lower business tax rate.* The United States has one of the highest statutory corporate tax rates in the world. Our tax code has many special provisions and consequently taxes some taxpayers at high effective rates and others at much lower effective rates. It is necessary to reform the tax code to lower business tax rates and remove special provisions.

(4) *An improved international tax system.* For businesses that operate across borders, it is important to modernize our international tax system. Most other countries have adopted a territorial tax system, which generally exempts from tax earnings from foreign operations. The U.S. system provides for deferral of tax on active foreign earnings until they are repatriated to

the United States. The high U.S. corporate tax rate and tax upon repatriation encourage U.S. companies to move activities offshore and keep earnings offshore (the lockout effect). The U.S. international tax system also creates an incentive for U.S. companies to use transfer pricing to shift income to lower-tax jurisdictions, and creates an incentive for U.S. companies to engage in inversions. Our international tax system needs to be fixed to address these problems.

DISTORTION IN DEBT FINANCING VERSUS EQUITY FINANCING

Question. A number of you in your written testimonies addressed the differing tax treatment of debt and equity.

The corporate marginal effective tax rate on equity financing is about 35% while the corporate marginal effective tax rate on debt financing is negative. This creates a huge distortion in terms of financing.

Corporations are incentivized by the tax code to engage in debt financing rather than equity financing.

As part of tax reform, should we create greater parity in the tax treatment of debt financing and equity financing and if so, how should we accomplish that?

Answer. Our corporate tax system is distortive because, unlike its treatment of other forms of doing business, it imposes two taxes on corporate earnings, once at the corporate level and again at the shareholder level (either on capital gains on disposition of stock or on dividends). The distortions caused by the corporate tax system include: (1) the disincentive to use C corporations (two levels of tax) rather than pass-through businesses (partnerships, limited liability companies, or S corporations) or sole proprietorships, for which there is a single level of tax at the owner level; (2) the incentive for corporations to use debt financing rather than equity financing; (3) the incentive for corporations to retain earnings and not pay dividends; and (4) the incentive for corporations to pay out earnings in ways other than dividends (such as the payment of deductible compensation, interest, rent and royalties).

Corporate integration could help eliminate the distortions caused by our corporate tax system. Integration could help equalize the treatment of debt and equity financing (for example by making dividend payments deductible like interest payments) or make their tax treatment more symmetrical (for example by providing a dividend exclusion for shareholders, so that dividends would be nondeductible and not includible in income, whereas interest payments would be deductible and includible in income).

There have been many studies of integration and the various ways it could be implemented. For example, in 1992 the Treasury Department issued a study about various options for corporate integration. More recently, in December 2014, the Republican staff of the Senate Finance Committee published "Comprehensive Tax Reform for 2015 and Beyond," which includes an extensive discussion about corporate integration. Each form of integration poses its own issues, and it would be necessary to evaluate those issues to determine which form would be best. It would also be important to consider each form of integration in the context of the overall tax reform package being considered to understand how it would fit within the larger package.

FASTER DEPRECIATION STIMULATES GROWTH?

Question. Mr. Solomon, in your testimony, you state that "economists agree that faster write-off of capital investments promotes economic growth by encouraging such investments."

I agree with that, but sometimes we hear from the management of publicly traded corporations that say they don't care about faster write-offs, because for financial accounting and reporting purposes, it's only a "temporary difference."

Now, you work at an accounting firm with a lot of accountants. You have a lot of publicly traded corporate clients. But you accurately reflected the views of a lot of economists.

So, who is right, the economists or corporate management?

Answer. Although faster cost recovery for capital investments might only result in a temporary difference for accounting or reporting purposes, timing of cost recov-

ery deductions has important consequences for the overall cost of an investment for cash flow purposes. Accelerated cost recovery results in lower taxes earlier in the life of an investment, which reduces the present value of taxes and results in a higher return. Higher returns lead to more investment, more production and a stronger economy, with accompanying benefits for workers and their families.

WHAT IF THERE IS NO TAX REFORM?

Question. What are your views on the consequences of not achieving comprehensive tax reform this year or early next year?

Does the lack of tax reform this year mean continued anemic economic growth and stagnant wages?

Does the lack of tax reform this year mean continued pressure for U.S.-based multinational firms to relocate abroad or be acquired by foreign multinational companies?

Answer. It is important to enact tax reform as soon as possible, to end uncertainty that could deter business and investment activity, and to provide benefits to American businesses, workers and families. Tax reform is necessary to adapt our tax system to an evolving U.S. and global landscape, to respond to global competitive pressures, to lower tax rates and remove distortions, to improve our international tax system, and to grow our economy. There is an opportunity now that we do not want to miss.

Without tax reform, problems caused by our current tax system will persist. For example, the problems caused by our current international tax system will continue, including the incentive to move activities and income offshore and keep earnings offshore (the lockout effect), the incentive to use transfer pricing to shift income to lower-tax jurisdictions, and the incentive for U.S. companies to engage in inversions.

INVERSIONS

Question. I am concerned about the wave of foreign acquisitions of American job-creating companies. I'm not just worried about existing U.S. jobs moving offshore, I'm worried about retaining the job prospects for future generations of Americans.

Does the relocation of a corporate headquarters impact local jobs in U.S. communities?

How can we help stem the tide of foreign acquisitions?

What type of tax rules would help American companies stay here and use the United States to not just serve U.S. customers but also to service foreign markets?

Answer. The United States is a favorable place to invest because of its large markets, its educated labor force, its level of innovation, its strong economy and its stable government. From a tax point of view, the best way to encourage U.S. companies to stay and invest here, and to encourage foreign companies to invest in the United States, is to provide a competitive tax system with low tax rates. As other countries revise their tax systems to adapt to global changes, the United States must respond as necessary to ensure that our system is in the best possible position to facilitate investment and maximize the welfare of the American people.

LAND TAX

Question. Dr. Peter Orszag recently asserted that "To fight inequality, tax land."[1] Is he correct that a tax on land would be distributionally progressive? That's not clear to me. If such a tax were to buy down tax rates on savings and investment, would such a tax be pro-growth?

Answer. I am not an economist and do not have expertise about the progressivity of a tax on land. I have consulted with economists at my firm, who indicate that whether a tax on land would be progressive, and how progressive, is a difficult issue. One question is whether progressivity is measured by income or wealth (for example, retirees generally have relatively lower income but may have relatively greater wealth). A second question is the identity of landowners (higher income or wealthier people versus lower income or less wealthy people). A third question is whether land can be disentangled from structures on land for purposes of the computing the tax. A fourth question is whether taxes on land are in fact borne by land-

[1] *See https://www.bloomberg.com/view/articles/2015-03-03/to-fight-inequality-tax-land.*

owners or whether they can be shifted to other people, such as renters. At this point there is an active debate about the progressivity of a tax on land.

SUMMARY QUESTION

Question. Given your prior role as the top tax policy advisor at the Treasury Department, what big-picture/summary advice do you have for us as we continue down this path toward comprehensive tax reform?

Answer. The debate about tax reform has been ongoing for over a decade. Extensive groundwork has been laid by the work of policymakers such as yourselves, academics, taxpayers, and practitioners. It is now essential to take the next step and enact tax reform that, among other things, reduces tax rates, eliminates various preferences, modernizes the international tax system, and helps American workers and families. If possible, the reforms should be permanent. In addition, tax reform should be distributionally neutral and fiscally responsible.

Despite the challenges in designing a new system, there is an opportunity now that we do not want to miss. It is important to act before the window shuts.

PREPARED STATEMENT OF HON. JONATHAN TALISMAN, FORMER ASSISTANT SECRETARY FOR TAX POLICY, 2000–2001, DEPARTMENT OF THE TREASURY

Chairman Hatch, Ranking Member Wyden, and members of the committee, it is a privilege to appear before you once again on a panel with my close friends and colleagues to discuss my thoughts regarding the important issue of tax reform. I want to commend the committee for your continued examination and pursuit of tax reform, to ensure that our tax system is fair, competitive and efficient, while raising the revenues we need to fund our Government. I am appearing here on my own behalf and not on behalf of my firm or any client.

I served at the Treasury Department beginning in early 1997 through President Bill Clinton's second term. Before that, I served on the Joint Tax Committee staff from 1992 to 1995, and then as Chief Democratic Tax Counsel to the Senate Finance Committee under Senator Daniel Patrick Moynihan.

Several of us appeared on a similar panel here over 6 years ago at a hearing entitled "How Did We Get Here?"[1] Given the general consensus among policymakers that tax reform has been needed, one might wonder why this hearing wasn't called "Why Are We Still Here?"

But, in all seriousness, I believe significant progress has been made in the interim period.

First, a few critical issues we discussed that needed reforms in 2011 have already been addressed. Because of structural defects, the Alternative Minimum Tax (AMT) was exploding and threatened to reach deep into the middle class, absent annual patches by Congress. As one commentator put it, the AMT was morphing from a "class" tax to a "mass" tax. As part of the fiscal cliff negotiations at the end of 2012, Congress agreed to boost the AMT exemption retroactively for 2012 and to index future exemption levels to keep pace with inflation. While some still want to eliminate the AMT entirely, this step prevented the unintended creep of the AMT, eliminated the need for annual patches, and provided taxpayers with greater certainty.

Similarly, in 2011, we had well over 100 extenders that were scheduled to expire later that year or the following year, including the 2001 and 2003 tax cuts. I said at the previous hearing, "It is unsustainable for much of our tax code to exist on a temporary basis." Fortunately, in the Protecting Americans From Tax Hikes (PATH) Act enacted in December 2015, Congress addressed a large part of the problem by extending numerous items either permanently or for 5 years. This included important provisions like the research credit, expanded small business expensing under section 179, bonus depreciation, and individual credits, such as the child tax credit, the earned income tax credit (EITC) and American opportunity tax credit. Unfortunately, a small number of expiring provisions were extended forward for only 1 year and thus expired at the end of last year. These need to be considered once again and include tax provisions for individuals and businesses, as well as several energy incentives.

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[1] Hearing on "How Did We Get Here? Changes in the Law and Tax Environment Since the Tax Reform Act of 1986," Senate Finance Committee (March 1, 2011).

Second, in both tax-writing committees, we have had a thorough examination of the principal options that exist to address the significant issues that remain (discussed below). Numerous hearings have been held (some have been repeated) and staff reports produced. Bipartisan working groups sought comments from outside sources and have made recommendations based on that input. Thoughtful discussion drafts and bills have been produced by Ranking Member Wyden, Senator Enzi, former Chairman Baucus, and former House Ways and Means Committee Chairman Camp that have allowed us to have an honest conversation about the tradeoffs likely in 1986-style reform that broadens the base to lower the rates. And the House Republican Blueprint, together with bills introduced by Senator Cardin, Representative Renacci, and Representative Nunes, have explored whether we should adopt a consumption (or quasi-consumption) tax to replace all or a portion of our income tax. All of these were important building blocks in the tax reform process.

I believe it is time for Congress to heed the instructions Yoda gave to Luke: "Do. Or do not. There is no 'try.'"

The prospect of tax reform has created uncertainty in planning, and crowded out work on other tax matters. So, in an effort to advance the cause of tax reform, let me briefly explore the principal remaining issues that should be addressed together with a few admonitions, and discuss some of the impediments to tax reform that remain.

SIGNIFICANT ISSUES STILL REMAIN THAT NEED TO BE ADDRESSED

The major impetuses for tax reform are: competitiveness and growth; efficiency; fiscal responsibility and long-term deficits; a shrinking middle class and economic inequality; fairness; and removing unnecessary complexity and administrative burdens. The first two have received the most attention to date, but all are important. My views on each of these are briefly summarized below.

Competitiveness and Growth. The United States has the highest statutory corporate tax rate among our major trading partners. When we lowered corporate tax rates in 1986, our rates were well below the OECD average. The problem is that all of our trading partners soon followed suit and kept moving past us. According to a report issued by the President's Economic Recovery Advisory Board (PERAB) in 2010, a high corporate tax rate "causes or exacerbates many . . . significant economic distortions."[2] The report called for broadening the tax base and lowering the corporate tax rate to "increase the stock of available capital—new businesses, factories, equipment, or research—improving productivity in the economy." The report also says that lowering the corporate rate would reduce the incentives of U.S. companies to shift operations and employees abroad. It would also enhance the attractiveness of the United States as a location for foreign direct investment.

At the same time, our quasi-worldwide international tax system,[3] adopted in 1918 and last structurally revised in 1962, has also become out of step with the rest of the world. Virtually all of our major competitors have adopted some form of territorial system, with the UK and Japan being the last major economies to switch away from a worldwide system in 2009. Among their stated reasons for changing their systems were to enhance their competitiveness as headquarter locations for multinational businesses and to spur repatriation of foreign income.

The combination of our worldwide tax base with the high U.S. tax rate often causes U.S. businesses to be at a competitive disadvantage in foreign markets relative to their competitors that are based in jurisdictions with lower tax rates or in countries that exempt foreign income. While deferral can mitigate competitiveness concerns, it does so only by creating a "lockout" problem—discouraging redeployment of foreign earnings for domestic investment. Our worldwide international tax system can hinder U.S. companies in bidding for foreign acquisitions, while at the same time making them more susceptible to foreign takeovers or to seek inversions.

Yet, with all of this, our current international tax system fails to raise much additional revenue from U.S. multinational corporations and, unlike a pure worldwide system, it does not achieve equity or capital export neutrality.

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[2] The President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation" (August 2010).

[3] Our international system is actually a hybrid—a worldwide tax system that permits deferral (*i.e.,* effective territorial treatment) until earnings are repatriated and provides foreign tax credits to avoid double taxation. This may be the worst of all worlds. As one commentator has written, our international tax rules "are universally reviled as just a half-step short of utter madness."

Globalization and migration of capital have heightened concerns about the competitiveness of U.S. businesses and our tax system, and focused attention on the need for international tax reform. Other countries are taking significant steps to attract headquarters, IP ownership, and other cross-border investment. At the same time, they are aggressively asserting additional rights to taxation at source—oftentimes seeking to tax profits that have only a tenuous connection to their country. The United States must respond soon to these global tax developments to avoid a detrimental impact to our economy and U.S. tax receipts in general.

Efficiency. Expanding the corporate tax base by eliminating special deductions, credits, and other tax expenditures could improve the efficiency of our tax system. In many cases, a broader tax base would improve neutrality by removing distortions that favor or disfavor various investments and industry sectors. Other countries have taken a similar approach when they have reduced their corporate tax rates over the past decade.

However, there are a few important caveats and tradeoffs that should be considered. Many of the largest "tax expenditures" are long-time features of our system embedded in the fabric of our economy. Moreover, as Stanley Surrey, the father of tax expenditure analysis, wrote with Paul McDaniel that "the classification of an item as a tax expenditure does not in itself make that item either a desirable or undesirable provision," and concluded that most were assistance "the legislators really do want to provide."[4] These include items such as the research credit (passed 15 times and made permanent in the PATH Act), employer-provided health exclusion (which has survived two recent health-care reform debates), deductibility of home mortgage interest, deductions for charitable contributions, incentives for retirement savings, reduced rates on capital gains and dividends, and exemptions for State and local bonds.

The primary consideration regarding whether to retain certain tax expenditures should be whether the intended result of the expenditure is still valid, whether the tax expenditure achieves its intended results in an efficient manner relative to the foregone revenue, whether these results are best achieved through the tax code (*e.g.,* relative complexity and administration), and what the potential economic and social dislocations would be if they were eliminated.

I would like to make two additional points. First, the definition of a tax expenditure is very broad (*i.e.,* any item that differs from the base of an idealized measurement of income) and subjective. For example, the State and local income tax deduction is designed to mitigate double taxation, like the foreign tax credit. One is listed as a tax expenditure; the other is not.

Second, in searching for additional sources of revenue to offset the cost of corporate tax reform, policymakers must be careful to avoid tax reform proposals that do more harm than good—that is, revenue proposals that limit ordinary and necessary business expenses. These proposals are counter-productive to the goals of tax reform. By overstating economic income, they arbitrarily raise certain businesses' effective rates above statutory rates, reducing fairness and impeding investment and growth. Such proposals would act as negative tax expenditures.

As I have written in *Tax Notes,* a case in point is the suggestion by certain policymakers that limits be imposed on the deductibility of business interest. Proponents argue that the imposition of such limits will reduce economic distortions caused by the different tax treatment of corporate debt and equity. But recent research suggests that the so-called "debt bias" has not led to over-leveraging or distress in the non-financial sector. In fact, Duke University Finance Professor John Graham has found that there is a significant degree of conservatism in corporate debt policy. Moreover, lowering the corporate tax rate will, by itself, reduce the value of the corporate interest deduction by 20 percent or more.[5] It also significantly lowers the double-level tax on equity. Finally, as Chairman Hatch has suggested, a partial or full dividends paid deduction would address the real problem (*i.e.,* the double level tax on corporations) and be a better solution. *Tax Notes* chief economist Marty Sullivan admits, "it would be far better to eliminate double taxation than to expand it through an elimination of interest deductions."[6]

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[4] Surrey and McDaniel, *Tax Expenditures* (1985).

[5] *See* Carroll, R. and Neubig, T., "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, May 2012), at 6.

[6] *See* Sullivan, "Treat Corporate Interest Deductions Like Any Tax Expenditure," *Tax Notes,* August 6, 2012, at 632.

Fiscal Responsibility and Long-term Deficits. In a response to questions for the record, CBO Director Keith Hall explained in detail the fiscal situation facing policymakers:

> If current laws generally remained the same, CBO projects, Federal spending would grow from 20.7 percent of GDP this year to 23.4 percent in 2027; Federal revenues would grow more slowly over that period—from 17.8 percent of GDP to 18.4 percent. About 70 percent of the growth in outlays over the next 10 years is attributable to just three sources: Social Security, Medicare, and net interest on Federal debt. To avoid the negative consequences of high and rising Federal debt and to put debt on a sustainable path, lawmakers would have to significantly change tax policies to increase revenues above what they are projected to be under current law, substantially amend spending policies to reduce outlays for large benefit programs below the projected amounts, or adopt some combination of those approaches.[7]

Obviously, it will be important for policymakers to keep our long-term fiscal situation and the impending demographic problems in mind in crafting tax reform to ensure we do not exacerbate our budget concerns.

Income Inequality and a Shrinking Middle Class. The issue of rising income inequality and the thinning of the middle class is a critical issue that should be addressed as part of tax reform.

According to my former Treasury colleague Len Burman, "the middle class has been in a 30-year recession."[8] Brookings Institution economist Adam Looney recently testified that earnings have stagnated for middle- and lower-income households, while they have "risen dramatically at the top—by more than 250 percent over the past 30 years for households in the top 1 percent of the income distribution."[9]

The progressive income tax has long served as an important bulwark against inequality: graduated tax rates require that high-income people pay a larger share of their income in taxes than lower-income people. According to Looney, "Changes in the tax system over the past 30 years have exacerbated these problems; the very people who have received the biggest income gains in the past three decades have also seen the largest tax cuts."

This is not a partisan issue. President Obama called rising inequality "the defining challenge of our time." Similarly, in the campaign, President Trump talked about a hollowed-out middle class and a system "rigged" against average Americans. Economists warn that it may be slowing overall economic growth. And the campaign demonstrated that a significant segment of the public feels left out, creating a "festering distrust of government and of corporate leaders whose promises of better times ahead never fully materialized."[10] One result has been a backlash against globalization and free trade that many Americans feel tilted the economy against them.

A recent op-ed by Glenn Hubbard, former chairman of the Council of Economic Advisors in the George W. Bush administration, suggests that the pro-growth agenda may not be sufficient to generate inclusion and mass prosperity.[11] I agree with him that policymakers "must confront the question of what happens when growth does not generate inclusion." Social factors may be at play that need to be overcome to provide greater opportunity. For example, as Senator Moynihan predicted years ago, single-parent families are more likely to be poor than other families and less likely to ascend the income ladder. Hubbard suggests the tax code should provide greater encouragement of human capital formation, education, and skills development.

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[7] Answers to questions for the record following a hearing on the budget and economic outlook for 2017 to 2027 conducted by the Senate Committee on the Budget, Congressional Budget Office (April 6, 2017).

[8] Testimony of Leonard E. Burman, hearing on "Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains, and Dividends," Senate Finance Committee (September 14, 2011).

[9] *See* testimony of Adam Looney, hearing on "Supporting Broad-Based Economic Growth and Fiscal Responsibility Through Tax Reform," Senate Budget Committee (May 22, 2013).

[10] *See* "Why It Matters: Income Inequality," Associated Press (August 18, 2016).

[11] *See* Glenn Hubbard, "Tax Reform Is the Best Way to Tackle Income Inequality," *Washington Post* (January 10, 2014).

Another positive step would be adoption of legislation proposed by Senators Brown and Bennet to expand the EITC for childless workers and to strengthen the child credit for families with young children. Studies have shown that economic insecurity has detrimental effects on children's long-term health, education, and employment outcomes, ultimately costing the U.S. economy hundreds of billions per year.

Fairness. The fairness of the tax code is highly subjective, but it will be critical to the success of any tax reform effort that it be perceived by the general public as fair. Fairness is generally based on ability to pay and notions of horizontal and vertical equity. Horizontal equity is the concept that similarly situated taxpayers should be taxed similarly. Vertical equity compares the treatment of taxpayers at various income levels and is generally measured by the progressivity of the overall system.

Certain tax expenditures are meant to address fairness and should be judged on that basis. For example, allowing deductions for catastrophic health expenses addresses the fact that these taxpayers have less disposable income and ability to pay. Also, ensuring that taxpayers cannot evade or avoid taxes imposed on other similarly situated taxpayers is important to perceptions of the tax system's fairness. The shutting of loopholes in the 1986 Tax Reform Act was a significant reason it was perceived to enhance fairness.

Simplification. The complexity of our tax rules is a significant concern. It affects economic growth by imposing substantial costs and administrative burdens on taxpayers. Complexity can also increase uncertainty as taxpayers struggle to ensure they are compliant in effecting their business decisions. In designing rules, we often should accept rough justice, rather than seeking to target the provision perfectly. For example, in response to a question from Senator Menendez, I testified at the last hearing that consolidation of the various education incentives is a good idea. The myriad of currently available incentives with different requirements creates confusion and complexity.

However, while simplification is desirable, some of the complexity of the code is unavoidable, and would be necessary in any tax system that is adopted. We have a complex economy and society that requires special rules to take into account different or unique circumstances in order to be fair or to prevent abuse. Another factor is our political dynamic. Since the early 1980s, there has been pressure not to increase spending but the political desire for new programs did not disappear. Accordingly, many new programs are being run through the tax code. Finally, much of the complexity and current instability in the code is caused by legislative efforts to meet our budget rules. Phase-ins, phase-outs, timing shifts, short-term extensions, and sunsetting of provisions are generally included to satisfy revenue constraints or other budget rules.

OVERCOMING IMPEDIMENTS TO TAX REFORM

So, given the strong consensus among policymakers that tax reform is needed, why hasn't it happened yet? Well, frankly, like health-care reform, it's hard. Health-care reform is visceral because it affects choices and our ability to care for our families and us. But it impacts only roughly 17 percent of GDP. Tax reform may be less visceral, but it impacts our everyday choices and our ability to provide for our families. And it impacts virtually 100 percent of GDP.

Also, while agreement exists that tax reform is needed (and despite all the work that has been done), there is still no clear consensus as to approach. Tax reform is defined in different ways. Important goals may conflict with each other. It will be important to agree on the goals and intended benefits of tax reform. Once these are established, it will be important for the President and other political leaders to market these goals and intended results to the American public.

The success of the 1986 Act was in no small part attributable to the initial sales job by President Reagan and Ways and Means Chairman Dan Rostenkowski. President Reagan delivered an Oval Office speech that called for revenue neutral tax reform to close loopholes and lower rates, saying "No other issue will have more lasting impact on the well-being of your families and your future." Rostenkowski delivered the Democratic response, saying that they were committed to a tax system that was simple and fair and would support the President if "his plan is everything he says it is." He then asked them to write Rosty: "Just address it to R-O-S-T-Y, Washington, DC. And stand up for fairness and lower taxes." He received more than

75,000 letters and one package with a wooden two-by-four with instructions to use it on any interfering lobbyists.

By definition, revenue-neutral tax reform will create winners and losers and cause disruptions. As Columbia Law Professor Mike Graetz has written:

> Since responsible tax reform in the current context cannot cut taxes overall, it inevitably will produce both winners and losers. Simplifying the tax code requires cutting back on someone's deductions or credits, eliminating someone's special tax breaks, and closing someone's loopholes. In exchange, everyone can have lower tax rates. So there should be more winners than losers. But the losers may lose a lot, while the more numerous winners will gain only a little. If so, the losers will scream loudly enough to drown out the winners' quiet applause.[12]

Engaging and educating the public is essential to build support and minimize blowback. While Chairman Baucus and Chairman Camp were on the right track with their road show, the electorate (and even rank-and-file members) has not truly been engaged yet in my opinion. Health-care reform has predominated the public's attention. How the goals for tax reform are established and marketed will determine whether any significant tax reform is accomplished, and how it is judged politically.

Another important lesson of the 1986 Act, as evidenced by the recent health-care debate, is that bipartisanship is important to develop major legislation that does not divide the American public and is lasting. As President Clinton recently said in a panel appearance with President Bush, "The truth is in an interdependent complex world, diverse groups make better decisions than homogeneous ones. . . ."

Consequently, like Chairman Hatch said in his recent speech to Bloomberg, "I am still hoping that tax reform can be bipartisan."

While a partisan approach to tax reform seems easier to accomplish, the truth is it creates numerous impediments that will be difficult to overcome. To provide reconciliation protection in the Senate, a budget resolution will need to be passed by both Houses, which will not be easy. Even if this can be accomplished, the margin for error in both bodies will be extremely slim, again as evidenced by the current problems facing the health-care bill. Finally, use of budget reconciliation can be a "Faustian bargain," as one of my Republican friends has termed it, invoking the Byrd rule and other procedural protections. This can inhibit what is ultimately accomplished, and may require that all or part of tax reform sunset outside the budget window a la the 2001 and 2003 tax cuts (or that artificial devices be adopted to avoid sunsetting).

Most business leaders are anxious for tax reform, but they are not yet unified in their vision for business tax reform. For example, a dispute still exists regarding the form of base erosion in a shift to a territorial system. The business community must find a way to come together and collectively help policymakers find solutions to reform the tax code in a manner that collectively benefits all, makes our system more competitive, and encourages domestic investment and job growth.

The recent focus on health-care reform and the novel issues raised by the border tax adjustments in the House Republican Blueprint have crowded out focus on other important, and potentially controversial, tax issues. These issues are just beginning to surface and may take time for members and staff to fully consider. For example, not much attention to date has been spent on proposed changes to individual taxation to double the standard deduction and eliminate the State and local tax deduction. This combined change will not only affect State and local governments, but also the charitable community and the housing sector. When Chairman Camp made a similar proposal in his tax reform bill, the number of itemizers eligible to take the charitable deduction and the home mortgage interest deduction was estimated to fall to 5 percent of all taxpayers, down from over 30 percent.

Another important but difficult issue that has not yet been vetted is the special tax rate for pass-throughs included in the administration's tax reform proposal, as well as the House Republican Blueprint. A detailed proposal for the design of a special pass-through rate has not been released. How it is perceived will depend in part on how it is designed.

I would like to close with a few final thoughts. First, do not worry about solving all perceived problems at once. Incremental progress will be a significant accom-

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[12] Michael Graetz, *100 Million Unnecessary Returns* (Yale Press 2008), p. 47.

plishment. In particular, debates over more fundamental tax reforms should not delay or preclude meaningful reforms to improve the current code that will provide relief to individuals and help stabilize the global tax environment and improve competitiveness for businesses operating in the United States. Second, be careful not to worsen or inhibit our ability to address our impending long-term fiscal problems. It will be more difficult politically to reverse course and unwind changes later.

Thank you for inviting me, once again, to share my observations. I stand ready to assist the committee in any way that I can as you move forward in your consideration of tax reform. I would be happy to answer any questions you might have.

QUESTIONS SUBMITTED FOR THE RECORD TO HON. JONATHAN TALISMAN

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

SIMPLIFICATION OF TAX SYSTEM—IMPACT ON INDIVIDUALS

Question. Individuals and small business owners spend billions of dollars complying with a labyrinth of tax rules every year.

What is the single most important thing Congress can do to help Americans save their hard earned time and money complying with our overly complex tax system?

Answer. To paraphrase my former boss Senator Moynihan, while the thought of a new set of simple rules is always appealing, we must recognize that we live in a complex society. Some amount of complexity is necessary and inevitable. Also, a major source of complexity is the need to file separate returns at the Federal and State level (often several States).[1]

Thus, I do not believe there is a single magic bullet. We should strive to eliminate needless and inefficient complexity. For example, each tax expenditure should be reexamined and evaluated as to whether the intended result of the expenditure is still valid, whether the tax expenditure achieves its intended results in an efficient manner relative to the foregone revenue, whether these results are best achieved through the tax code (*e.g.,* relative complexity and administration), and what the potential economic and social dislocations would be if it is eliminated.

As an illustration, I believe simplification through consolidation of the various education incentives is a good idea, and something that can be realistically achieved. The myriad of currently available incentives with different requirements creates confusion and complexity. We should also conform qualification requirements (*e.g.,* the definition of qualified educational expenses), to the extent possible.

GROWTH AND PROGRESSIVITY

Question. Many of us are very disturbed at the low rates of growth our economy has experienced for several years now.

So, one of the main drivers of tax reform is the desire to help achieve higher growth rates.

But we also hear a lot about progressivity and distribution.

So, my question is, to what extent, if at all, are the goal of growth and the goal of progressivity in tension with each other?

Answer. According to a recent study by the IMF analyzing tax rates in OECD countries between 1981 and 2016, there is no strong relationship between how progressive a tax system is and economic growth. Indeed the study adds that for countries wanting to address income inequality, there may be "scope for increasing the progressivity of income taxation without significantly hurting growth."

Also, as I stated in my testimony, growth does not necessarily foster inclusion. We have had significant economic growth in this country over the past 3 decades, but "the middle class has been in a 30-year recession." Growth by itself is not enough—it has to translate to jobs and middle-income wage growth. A recent op-ed by Glenn Hubbard, former chairman of the Council of Economic Advisors in the Bush administration, agrees that the pro-growth agenda may not be sufficient to

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[1] For another time, this is an issue that should be examined. States should be encouraged to piggyback on the Federal system, and to eliminate duplication of effort. This could be modeled after the streamlined sales tax project (SSTP).

generate inclusion and mass prosperity. Hubbard suggests the tax code should provide greater encouragement of human capital formation, education, and skills development.

Economists have warned that rising income inequality may be slowing overall economic growth. Thus, addressing income inequality and the thinning of the middle class should be a priority and is consistent with a pro-growth agenda. Conversely, reform that is pro-growth, by itself, is not enough to address inequality.

HIGH IMPORTANCE FOR BUSINESS

Question. Each of you interacts with and advises small and large businesses on a daily basis.

What are these businesses telling you is most important to them as part of tax reform?

What are the major themes you're hearing from large and small businesses alike?

Answer. The combination of our worldwide tax base with the high U.S. tax rate has caused our tax system to be an outlier from the rest of the world. U.S. businesses believe they are at a competitive disadvantage in foreign markets relative to their competitors based in jurisdictions with lower tax rates or in countries that exempt foreign income. While deferral can mitigate competitiveness concerns, it does so only by creating a "lockout" problem—discouraging redeployment of foreign earnings for domestic investment. Our worldwide international tax system can hinder U.S. companies in bidding for foreign acquisitions, while at the same time making them more susceptible to foreign takeovers or to seek inversions.

DISTORTION IN DEBT FINANCING VERSUS EQUITY FINANCING

Question. A number of you in your written testimonies addressed the differing tax treatment of debt and equity.

The corporate marginal effective tax rate on equity financing is about 35% while the corporate marginal effective tax rate on debt financing is negative. This creates a huge distortion in terms of financing.

Corporations are incentivized by the tax code to engage in debt financing rather than equity financing.

As part of tax reform, should we create greater parity in the tax treatment of debt financing and equity financing and if so, how should we accomplish that?

Answer. As I stated in my testimony, I believe it would be a mistake to eliminate interest deductibility to reduce any purported debt bias. Interest expense is as an ordinary and necessary business expense that is essential to fairly compute the economic income generated by U.S. businesses.

Also, by itself, lowering the corporate tax rate should significantly mitigate any tax bias for debt by decreasing the value of the corporate interest deduction and reducing the impact of the double-level tax on equity. The real problem is the double-tax on C corporations.[2] A far better solution would be to adopt some form of corporate integration.

While debt and equity both raise needed investment capital, they serve distinct non-tax purposes for both the investors and the corporation and are not substitutes for each other. Generally, debt is a secured liability, with fixed and determinable repayment obligations and priority of repayment in the case of bankruptcy. The issuance of debt is non-dilutive for the shareholders. Also, debt generally is cheaper to issue than equity and is often easier to access to meet unforeseen business needs, particularly for small and privately held businesses. Equity is the ownership interest held by shareholders who control corporate decision-making. Shareholders are entitled to residual profits and going-concern value after all business expenses, including interest expense and taxes, are paid. Unlike debt, the return of equity is less predictable and is not guaranteed, and equity interests are more expensive because they are unsecured.

Finally, studies show that any tax-driven bias for debt, leading to significant overleveraging, may be exaggerated. For example, a recent study found that there is a significant degree of conservatism in corporate debt policy, perhaps partially im-

[2] *Tax Notes* chief economist Marty Sullivan admits, "it would be far better to eliminate double taxation than to expand it through an elimination of interest deductions."

pacted by the tax cost of debt to individuals. Any purported tax bias for debt may also be muted because corporate decisions regarding the level of debt are policed by numerous non-tax market forces, such as requirements imposed by lenders, investors, regulators, rating agencies, analysts, and others.

WHAT IF THERE IS NO TAX REFORM?

Question. What are your views on the consequences of not achieving comprehensive tax reform this year or early next year?

Does the lack of tax reform this year mean continued anemic economic growth and stagnant wages?

Does the lack of tax reform this year mean continued pressure for U.S.-based multinational firms to relocate abroad or be acquired by foreign multinational companies?

Answer. Other countries are taking significant steps to attract headquarters, IP ownership and other cross-border investment. At the same time, they are aggressively asserting additional rights to taxation at source—often times seeking to tax profits that have only a tenuous connection to their country. It is important that the United States respond soon to these global tax developments. However, it is also important that any tax reform efforts be balanced and not impede our ability to respond to the impending demographic and fiscal challenges.

BENEFITS-RECEIVED TAXATION

Question. You discussed the importance of fairness in the tax system in your testimony. I agree with you as to the importance of fairness.

My question is, to what extent, if any, do you think that an appropriate measure of a tax's fairness is that the amount of the tax correlates with the benefit the taxpayer receives from the government?

Answer. "Benefits-received" taxation is a long-recognized measure of fairness in taxation. It works well when the benefits received are directly correlated with the tax being imposed. The best examples of this are a toll imposed for use of a bridge or highway, or postage paid for mailing a letter. Social security taxes are arguably another example, although benefits are not perfectly correlated with the amount of tax collected.

Benefits-received taxation works less well when the benefits received are highly subjective and difficult to measure. For example, what is the value of a justice system or national defense to each particular household? In general, one would think that property owners and wealthier households have more to lose if anarchy prevails or the country is overtaken. Thus, imposing a higher tax on these households may make sense but by how much? Also, the benefits principle does not work well with respect to anti-poverty programs. If we were to tax the people who received benefits from these programs, the programs (when combined with the taxes) would not accomplish much to reduce poverty. This is why we use an "ability to pay" concept to impose income and certain other taxes to cover general government services.

INVERSIONS

Question. I am concerned about the wave of foreign acquisitions of American job-creating companies. I'm not just worried about existing U.S. jobs moving offshore, I'm worried about retaining the job prospects for future generations of Americans.

Does the relocation of a corporate headquarters impact local jobs in U.S. communities?

How can we help stem the tide of foreign acquisitions?

What type of tax rules would help American companies stay here and use the United States to not just serve U.S. customers but also to service foreign markets?

Answer. Corporations seek inversions because of a few fundamental features of the U.S. tax code: the differential treatment of foreign earnings by U.S.-based and foreign-based companies, the ability to strip earnings overseas, and the lockout effect on foreign earnings exacerbated by the high U.S. corporate tax rate.

According to recent testimony before the Committee by Professor Grinberg, recent studies "suggest that when foreign companies expand outside the United States, related headquarters investment and employment would tend to accrue in their home country. Importantly—this turns out to be the case even with formerly U.S.-tax resi-

dent corporations that have substantial presence in the United States but change their country of tax residency."

Legislation has been used as a stopgap measure to halt inversions, but it has not solved the fundamental problems that cause companies to invert. Also, these approaches can frustrate non-tax motivated mergers designed to capture synergies between companies.

Corporate tax reform is the best way to slow the spate of foreign acquisitions and inversions. Reducing the corporate tax rate while also changing the taxation of foreign earnings to a dividend exemption (territorial) approach would certainly help make inversions less attractive. However, U.S. companies may continue to have an incentive to relocate to a foreign country to avoid U.S. base erosion rules and our subpart F regime, and possibly to continue to strip earnings into a country with a still lower tax rate. The benefits of a lower rate and adoption of a territorial approach will need to be carefully weighed against the potential consequences for the U.S. economy if it leads to a significant overall reduction in tax revenue, and creates incentives to shift U.S. profits and operations overseas.

INTEREST DEDUCTION

Question. Some proposals for tax reform have suggested that interest deductibility should be replaced with 100% immediate capital expensing.

Do you believe that eliminating interest deductibility in favor of 100% expensing is a reasonable trade-off for companies? If not, why?

Also, conceptually, should individuals be able to claim a deduction for interest expense that helps generate investment income? If such interest should be deductible, should it be deductible as an itemized deduction, or rather as an above-the-line deduction in arriving at Adjusted Gross Income?

Answer. As I testified, I do not believe that eliminating interest deductibility for 100% expensing of capital investment is a wise trade-off. It may have a short-term benefit. Over time, however, it will raise the cost of capital, reducing investment, job creation and economic growth. A recent Goldman Sachs report confirms this, saying "The two policies would roughly offset over the first year, boosting investment by less than 1 percent," but over the longer run, the proposals "would raise the user cost of capital and reduce investment." Interest is an ordinary and necessary cost of doing business that should continue to be deductible to accurately measure economic income.

If we had an ideal income tax, all interest expenses incurred in profit-seeking activities should be currently deductible. But because our income tax is a hybrid with consumption-like features (exclusions, deferral, and rate differences), there is potential for tax arbitrage if a current deduction is allowed for the interest expenses associated with the production of tax-favored income. Thus, the investment interest limitation was adopted as a means to match income and expense and limit any arbitrage.

LAND TAX

Question. Dr. Peter Orszag recently asserted that, "to fight inequality, tax land."[3] Is he correct that a tax on land would be distributionally progressive? That's not clear to me. If such a tax were to buy down tax rates on savings and investment, would such a tax be pro-growth?

Answer. I agree with Dr. Orszag that a tax on land is distributionally progressive, since high value property owners generally are higher income taxpayers. However, as the question points out, the level of its overall effects on progressivity will depend on whether it is an add-on tax or substitutes for another progressive tax (*e.g.,* taxes on savings).

This begs the question whether it is a good idea. A tax on land is hard to avoid, helps to address income inequality and may foster investment in more productive forms of capital. On the other hand, it is not clear to me that singling out land from other wealth for federal taxation is fair or makes sense. Also, it is important to note that many states already impose property taxes on land values. Imposing a double tax on land could discourage home ownership and property development. Finally, assessing the land without improvements could be difficult.

[3] *See https://www.bloomberg.com/view/articles/2015-03-03/to-fight-inequality-tax-land.*

REINSURANCE PREMIUMS AND EARNINGS STRIPPING

Question. Are reinsurance premiums often paid to affiliated foreign corporations for the purpose of stripping taxable income from the U.S. tax base?

Aren't there many ways to engage in earnings stripping?

Is it reasonable to think Congress could devise one rule to restrict all types of earnings stripping?

Answer. Use of deductible reinsurance payments to a foreign affiliate is a common means for foreign-parented insurance companies to strip income out of the United States to a low-tax or no-tax jurisdiction.

Over the past 2 decades, several companies have formed or moved abroad to take advantage of this income-stripping technique, through inversions, redomestications and foreign acquisitions. For example, Bermuda and Swiss-based Ace recently acquired Chubb, previously one of the largest U.S. P&C companies. Just this past month, U.S.-based Assurant announced it would merge into the Warranty Group, a Bermuda-based company presumably to take advantage of the use of affiliate reinsurance. According to industry experts Dowling and Partners, the proposed shift by Assurant overseas could "put the outside range of loss to the U.S. Treasury at approximately one-half of Assurant's current tax bill ($240M in 2016)."

While affiliate reinsurance is similar to many other forms of related-party payments (*e.g.,* interest, royalties) used to strip income overseas, one significant difference is that affiliate reinsurance is used primarily to shift a company's investment reserves out of the U.S. to avoid tax.

Insurance companies have two forms of income that are subject to tax: (1) underwriting income—generally, the amount by which premiums earned exceed losses incurred plus expenses; and (2) investment income—the earnings from investing reserves before claims are paid. Because the combined ratio[4] for many lines of business is close to (or even over) 100%, much if not all of an insurance company's taxable income is derived from its investment income. Consequently, if a company can strip its investment reserves on U.S. business outside the U.S., it can avoid tax on much of its net income from U.S. written business. It also allows them to avoid U.S. rules requiring discounting of loss reserves, which accelerate the payment of taxes by domestic groups.

If a one-size-fits-all approach is adopted to adopted to address base erosion from related-party payments, it will need to account for these two unique and essential features.

SUMMARY QUESTION

Question. Given your prior role as the top tax policy advisor at the Treasury Department, what big-picture/summary advice do you have for us as we continue down this path toward comprehensive tax reform?

Answer. For the sake of consistency, I would reiterate a few themes from my testimony. First, I believe engaging and educating the public is essential to build support and minimize blowback. The electorate has not fully been engaged yet in my opinion. How the goals for tax reform are established and marketed will determine whether it is perceived as fair, whether it is accomplished, and how it is judged politically. Second, do not worry about solving all perceived problems at once. Incremental progress will be a significant accomplishment. Debates over more fundamental tax reforms should not delay or preclude meaningful reforms to improve the current code that will provide relief to individuals and help stabilize the global tax environment and improve competitiveness for businesses operating in the U.S. Finally, be careful not to worsen or inhibit our ability to address our impending long-term fiscal problems. It will be more difficult politically to reverse course and unwind changes later.

[4] The combined ratio is the losses incurred plus expenses over earned premiums.

SUBMITTED BY HON. JOHN THUNE, A U.S. SENATOR FROM SOUTH DAKOTA

Reforming the Taxation of Pass-Through Businesses

Bipartisan Policy Center Staff Working Paper

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Executive Summary

The Trump administration and Congress are actively developing tax reform legislative proposals. One key issue policymakers will address is how to reform the tax treatment of pass-through businesses. Pass-through businesses are businesses, large and small (including S Corporations, partnerships, LLCs, and sole proprietorships), where the business itself does not pay tax but instead where taxes are paid directly by the individual owners of the business.

In this type of business structure, income, credits, and deductions realized by the businesses "pass through" to the individual owners, who pay tax on that income according to the tax rates and brackets on the individual side of the tax code, as opposed to the rate for C corporations. Thus, if tax reform eliminates or curtails business-related credits or deductions and does not provide them with a corresponding reduction in the tax rates, these types of businesses could experience a significant tax increase.

In 2013, the latest year for which IRS statistics are available, 3.6 million partnerships and 4.3 million S corporations filed tax returns. This compares with 5.9 million C corporations who filed tax returns that year.[1] These pass-through businesses include small start-ups and mom-and-pop businesses that represent the entrepreneurial spirit of the U.S. economy. How pass-through businesses are treated in any tax reform agenda is critical to the future of American business.

This paper provides a menu of options policymakers could consider when reforming the taxation of pass-through businesses. This paper does not assume that the tax rates for pass-through businesses have to be identical to those applied to income earned by individuals unrelated to the pass-through business. These options attempt to balance the desire to avoid tax increases on pass-through businesses while also ensuring that pass-through businesses do not become a means for wealthy individuals to avoid tax on income that should be properly subject to tax at individual tax rates. These options include:

- Limiting what types of businesses or business activity could benefit from lower tax rates on pass-through businesses;
- Creating incentives for the owners of pass-through businesses to reinvest profits into the business; and
- Rules to limit the total amount of income that could qualify for a lower pass-through rate.

Introduction

The Bipartisan Policy Center engaged in a yearlong examination of the issues surrounding corporate- and business-tax reform. BPC's goal throughout has been to increase and enhance the competitiveness of U.S. companies and workers, increase economic growth, and thereby increase job creation, wage growth, and investment.

This paper, which results from that effort, focuses on one aspect of business-tax reform: pass-through businesses. It is intended to identify the issues that must be con-

[1] IRS, Statistics of Income, Business Tax Statistics. Available at: *https://www.irs.gov/uac/tax-stats.*

fronted by policymakers when integrating corporate-tax reform with pass-through entities. It also provides policymakers with a range of options for addressing this integration as they reform the business aspects of the U.S. tax code.

The project focused on reform of the business-related aspects of the tax code and therefore is not dependent on tax reform that might make changes to the individual code. In addition, when considering the various policy options, it is necessary to be able to consider them in the context of what the current tax rate on C corporations would be after reform. For the purposes of this paper, BPC has assumed a post-reform corporate-tax rate of 25 percent.[2]

It is assumed that the revenue loss associated with lowering the corporate rate to the post-reform rate of 25 percent (an estimated reduction in tax revenues of approximately $1.2 trillion over 10 years) would be offset, at least in part, by broadening the tax base.[3] This would be accomplished through the elimination or curtailment of credits, deductions, and other policies that businesses currently use to lower their effective tax rates. Because BPC's work focused on business-tax reform, it does not assume changes in individual tax rates. Therefore, any broadening of the tax base would increase the pass-through businesses' tax liability, without any offsetting benefit of a reduction in tax rates.[4]

This paper describes a series of options for addressing broad policy issues to ensure pass-through businesses are not made less competitive by tax reform that does not simultaneously lower individual rates.

Proposed options for four broad policy questions:

1. What tax rate should be applied to pass-through businesses?
2. What types of business activity should qualify for the pass-through tax rates?
3. What share of qualifying income should benefit from the pass-through tax rates?
4. What policies should be included to prevent abuse and simplify administration of the reformed code?

This paper also concludes with a discussion of other related policy changes that could be incorporated into the integration process.

Question 1: What Tax Rate Should Be Applied to Pass-Through Businesses?

Options for Tax Rates for Pass-Through Businesses

Effective Federal Marginal Tax Rates

BPC's work on business tax reform does not assume the elimination of the existing second layer of tax on corporate income that results from the taxation of dividends. As a result, the effective tax rate on corporate income paid out to shareholders may be higher than the 25 percent assumed in this paper, as this income is still subject to taxes on dividend income received by shareholders. Pass-through entities, which are not subject to corporate tax at the entity level, do not face this double-tax situation. As a result, policymakers may consider that full parity between the corporate rate and the maximum rate on the business income of pass-throughs is not essential.

Analysis by the Treasury Department has found that under current law, C corporations face an effective federal marginal tax rate of approximately 30 percent, while pass-through entities face an effective tax rate of approximately 25 percent.[5] (This analysis does not include state corporate tax rates that can increase the effective marginal tax rate.) In a similar analysis, the Congressional Budget Office found that C corporations in 2014 paid an effective rate of 31 percent, while pass-throughs paid an average rate of 27 percent. Thus, because pass-throughs are not burdened by the double tax, currently their marginal rates are effectively between 4 and 5 percentage points lower than those for corporate-rate taxpayers. As a result, pass-

[2] This paper assumes a flat corporate rate of 25 percent applied to the first dollar of taxable income.

[3] $1.2 trillion assumes each percentage-point reduction in the corporate rate results in approximately $120 billion in revenue loss over the 10-year budget window.

[4] The increase in taxes on pass-through businesses that would occur if tax reform broadened the tax base on pass-through businesses without any accompanying reduction in tax rates would make pass-through businesses less competitive vis-a-vis C corporations in situations where the pass-through business competes directly with the C corporation.

[5] Economic Report of the President, February 2015, 230. Available at: *https://www.gpo.gov/fdsys/pkg/ERP-2015/pdf/ERP-2015.pdf.*

throughs could be subjected to a somewhat higher tax rate than C corporations and still be effectively on parity with the effective tax rate for C corporations.

Interaction With Progressive Individual Tax Rates

In addition, under current law, pass-throughs receive the benefit of the lower individual tax rates (relative to the rate for corporations) that apply at lower income levels.[6] Thus, some amount of income is taxed at rates much lower than the current C corporation rate of 35 percent. If pass-through entities are provided with a lower rate on qualifying income, policymakers could choose to maintain pass-throughs' access to the lower individual rates.

For example, if the maximum pass-through rate were 28 percent, pass-throughs could be taxed at the lower rates of 10, 15, and 25 percent on income below $190,151—the threshold for entry into the current 33 percent bracket. Allowing pass-throughs access to these lower rates would reduce the effective rate of taxation.[7] Alternatively, pass-throughs could be subjected to one flat rate on all their business income, in a manner analogous to how various tax-reform proposals would treat C corporations.

For purposes of this options paper, as previously stated, BPC assumes that corporations would be subject to one flat rate of 25 percent. Therefore, policymakers should consider whether applying one flat rate could result in some small pass-through entities facing a tax increase. For example, a pass-through owner who had taxable income of $100,000 would face an effective tax rate of approximately 21 percent if filing as an individual and approximately 19 percent if filing a joint return. Both are below 25 or 28 percent under current law. Thus, the application of one flat rate would result in a tax increase, even before the impact of any base broadening.

"Claw Back" of High-Income Pass-Throughs

If policymakers are concerned about the revenue loss or distributional consequences associated with permitting pass-through entities to maintain access to the lower rates, policymakers could include a "claw-back" option for high-income pass-throughs.[8] A claw-back provision would recapture the benefit of the lower rates for pass-throughs with income over a certain threshold. Such a policy could be implemented in a way that protects smaller pass-through entities from tax increases that would result from the loss of access to the lower rates. For example, the phase-out could be implemented in a way that does not increase the effective tax rate for pass-throughs with taxable income below the top pass-through rate. At the same time, this policy would reduce the overall revenue loss from the new top pass-through rate by limiting the benefit of the lower rates for high-income pass-throughs.

Question 2: What Business Activity Should Qualify for the Pass-Through Rate?

Options for Determining What Business Activity Qualifies for Lower Pass-Through Business Rates

When creating a separate tax rate structure for pass-throughs, policymakers must also identify what type of activity is eligible for the separate rate structure. Conceptually, policymakers may wish to permit only certain types of income directly related to the business activity of the pass-through business to benefit from the separate rate structure. In particular, they may want to limit the access to the lower rates to only what policymakers would consider *non-labor income,* which would re-

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[6] For example, an individual filer is subject to a tax rate of 10 percent on the first $9,275 in income, a tax rate of 15 percent on income over that but not exceeding $37,650, a rate of 25 percent on income over that but not exceeding $91,150, and so on with progressively higher income brackets and rates. *See:* IRS, "IRS Tax Brackets and Deduction Amounts for Tax Year 2016: Federal Tax Rates, Personal Exemptions, and Standard Deductions," 2016. Available at: *https://www.irs.com/articles/2016-federal-tax-rates-personal-exemptions-and-standard-deductions.*

[7] For example, assume a pass-through with $250,000 in qualifying income. The effective tax rate on that income would be approximately 25.2 percent: (10% * $9,275) + (15% * ($37,650 − $9,276)) + (25% * ($91,150 − $37,651)) + (28% * ($250,000 − $91,151)).

[8] A similar concept applies in current law with regard to the corporate rate. Although often glossed over, the current corporate tax rate is progressive with a rate of 15 percent on the first $50,000 in taxable income, 25 percent on the next $25,000 in taxable income, and 34 percent on income between $75,000 and $10 million. As a corporation's taxable income rises, it loses the benefits of the 15- and 25-percent rates (beginning when a corporation has taxable income over $100,000) and the 34 percent rate (beginning when a corporation has taxable income over $15 million). *See* Joint Committee on Taxation, "Overview of the Federal Tax System as in Effect for 2016," JCX–43–15, May 10, 2016. Available at: *https://www.jct.gov/publications.html?func=startdown&id=4912.*

sult in the lower rate applying only to income that is generally analogous to the types of income that would benefit from a reduction in the corporate tax rate.

As noted, policymakers may wish to treat certain types of activity, regardless of whether it's related to a pass-through or a C corporation business, the same when the individuals engaging in that activity would typically be taxed under the individual side of the tax code. For example, the provision of certain services can be done through both pass-through and C corporation businesses. Policymakers may wish to ensure that the individuals providing such services are taxed in the same manner. These types of activity include, among others, legal and accounting services where individuals provide the same types of service in both pass-through and C corporation businesses, but in the context of the pass-through businesses, the individuals may also be the owners of the business. If these types of activity were eligible for the pass-through tax rates, the income of the pass-through owners would qualify for the same pass-through rates.[9]

Policymakers, therefore, could limit access to the separate pass-through regime by excluding certain types of activity from qualifying. For example, they could exclude income arising from the provision of personal services from qualifying for the lower pass-through rates. Such personal services are already defined in the tax code as any activity performed in the fields of health, law, engineering, architecture, accounting, actuarial science, architecture, performing arts, or consulting.[10]

Also, policymakers could limit the type of income that qualifies by prohibiting passive income, from investments or other sources, from qualifying for the pass-through tax rates.[11] Income from such sources as royalties, rents, dividends, and interest would therefore be excluded from qualifying. Such a limitation would focus the benefits of the pass-through tax rates on active income.

Alternatively, policymakers could specify what types of income qualify, with all other income not qualifying for the pass-through rates. For example, policymakers could determine that only certain manufacturing income would qualify. They could limit the benefits of the pass-through structure to only activity that currently qualifies under the Section 199 deduction for manufacturing.[12] There is considerable precedent as to what types of activity qualify for Section 199, thereby making the administration of the separate rate easier. In contrast, however, there are several different types of business activities that would not qualify for Section 199, such as retail businesses that are generally considered "small businesses."

Policymakers could develop additional definitions to Section 199, such as for retail establishments. The Census Bureau maintains a definition of what qualifies as retail sales for the purpose of reporting on economic indicators.[13]

Question 3: What Share of Qualifying Income Should Benefit From the Pass-Through Rates?

Options for Determining What Share of Qualifying Income Benefits From the Lower Pass-Through Rates

In addition to determining what types of income can qualify for the separate pass-through rate, policymakers can also make determinations as to the amount of such income that can qualify. Determining how much income can qualify is predicated on policymakers' goals for how the separate rate would impact taxpayer behavior. For example, if policymakers have a goal of encouraging pass-through owners to invest more in their company, then rules would be designed to encourage that activity. However, if they wish to reduce administrative complexity, they might permit all the qualifying income to benefit from the pass-through tax rate.

In addition, a certain amount of the income earned by the business owner is likely compensation for work performed by the owner, as opposed to a return on the owner's capital. Therefore, some share of the income may be better qualified as analo-

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[9] An extreme option would be to require all companies providing such services to be taxed as corporations, such as by subjecting them to taxation as personal service corporations as defined in IRC 269A.

[10] Internal Revenue Code 448(d)(2)(A).

[11] Policymakers could define such income as income covered by Internal Revenue Code 1362(d)(3).

[12] Section 199 (or the domestic-production deduction) provides a deduction against qualified business income that is intended to provide tax relief equivalent to a 3-percent reduction in the taxpayer's effective tax rate.

[13] U.S. Census, Monthly and Annual Retail Trade, March 2017. Available at: *https://www.census.gov/retail/index.html.*

gous to wages or salary and therefore taxed at the regular individual tax rates. Under current law, notions of "reasonable compensation" apply for S corporations. In this circumstance, the owner is required to receive a reasonable amount of compensation to ensure that income that is more accurately considered labor income is taxed at individual rates and therefore subject to payroll taxes. That same concept can be applied in a separate rate structure for pass-throughs.

From a design standpoint, policymakers can approach this question by distinguishing between income and assets. An income-based approach may be less complicated to administer but also less likely to create incentives to reinvest in the business. An asset-based approach would more directly tie to incentives for the owner to increase their capital investment in the business, but it would also be more complicated to account and administer.

Income-Based Approach

An income-based approach is less complex, and potentially, one structure could be applied to all types of pass-through entities. Under this approach, the pre-tax profit of the entity that is attributable to the owner based on their share of ownership in the entity would be eligible for the pass-through tax rates. Thus, if an S corporation has four owners each with an equal share in the company and the pre-tax income of the entity is $1 million, then each owner would be able to qualify an amount up to $250,000 for the pass-through tax rates.

Policymakers could further limit the amount of income that qualifies by limiting the share of qualifying income to a ratio equivalent to income reinvested in the business by the owner or by imposing other explicit ratio limitations to be discussed below.

Policymakers could limit the benefit of the pass-through tax rates in circumstances where the business is in a loss position by prohibiting the owners from applying their share of those losses to other, non-qualifying income. In such a circumstance, the losses could be carried forward as a net operating loss applied against future positive qualifying income.

Asset-Based Approach

Using an asset-based approach to determine the share of income qualifying for the pass-through rate, the income associated with the return on contributions of capital by the owner of the pass-through entity would determine the amount of income that qualifies. Income associated with the return on labor or services provided by the owner of the pass-through could continue to be taxed at the regular individual rates.

Each of the types of pass-through entities—for example, S-Corp, partnerships, LLC, sole properties—have existing rules and structures that can be used as the basis for measuring the amount of return on capital invested by the owner in the business. One asset-based policy that is common to all forms of pass-throughs requires that any capital—in the form of property, equipment, equity, etc.—contributed to the business by an owner be valued according to fair market value at the time of the contribution. Any built-in gain at the time of the contribution would therefore be included in the valuation.

S Corporations

S corporations present a special case for determining the share of income qualifying for pass-through rates when using an asset-based approach for valuation. In an S corporation structure, the owners receive stock in the company. This stock forms the basis of the owner's share of the corporation. Stock is received in exchange for contributions of capital, including property. The owner's basis (*i.e.,* the value at the time of contribution) in the stock changes over time based on earnings, distributions, and depreciation. One policy option would be to use the value of the owner's stock (*i.e.,* outside basis) in the S corporation as the metric for tracking the amount of, and return on, capital contributed and owned by the individual owner.[14] Such an approach would likely require some businesses that currently do not closely track the value of their stocks to begin doing so. It may also require companies to clearly establish basis value at the time of the new tax structure.

This structure could be applied on a prospective basis only and require the owner to have identified and documented the value of their basis before being able to qualify income for the separate rate structure. Policymakers could also require that the owner's basis in the pass-through be positive before any income could qualify for the

[14] Generally, the inside basis of an S corporation is a measure of the value of the property held by the business entity. The outside basis is a measure of the value of the owner's S corporation stock.

pass-through rate. Thus, capital invested to return the owner's basis to a positive basis would not be included in the calculation as to how much of the owner's income is eligible for the pass-through rate.

The net change in basis at the end of a specified period would determine the amount of income received by the owner that qualifies for the pass-through rate. This rate would be applied to the share of the individual's ownership in the S corporation. In order to smooth out volatility, the change could be averaged over more than one year. For example, assume that after year one the owner's basis increased by 20 percent, at the end of year two the owner's basis declined by 10 percent, and at the end of year three the owner's basis increased by 8 percent. Over the three-year period, the owner's basis increased by an average of 6 percent. Thus, the owner could qualify 6 percent of any income for the pass-through rate.[15]

The change in basis could be calculated more simply. The owner's initial basis in year one is $1 million. In year two, the owner contributes $200,000 in new capital. In year two, the owner's share of the depreciation is $50,000. The net change in capital (new capital less depreciation) is $150,000. So, the percentage applicable for that year would be 15 percent (150,000/1 million × 100 = 15 percent).

This 15 percent would be used to determine the share of the owner's income from the pass-through that would be subject to the pass-through rate. Assuming the pass-through owner keeps access to the lower individual rates (as discussed in the prior section) this ratio would apply only to the share of income above the threshold for the top pass-through rate. For example, assuming the pass-through rate is 28 percent, the 15 percent ratio would be applied to any income received in excess of $190,151, the entry point of the 33 percent bracket for single filers. In this tax structure, if the owner's basis in the company declines year over year, the owner could not qualify any income for the pass-through rate.

Further, policymakers could limit this tax structure only to owners who have contributed capital to the corporation regardless of the owner's status as an active or inactive participant. Thus, passive owners who do not contribute capital to the business would not be eligible for the pass-through rate. In the case of ownership in an S corporation where the owner's share was a gift, policymakers could apply existing carryover rules under current gift rules. This would effectively reduce or eliminate any basis in the S corporation the recipient of the gift could claim. If policymakers took this approach, it would create a strong incentive for the new owner to invest new capital into the business in order to obtain the basis used to qualify income for the pass-through rate.

Partnerships and LLCs

Unlike S corporations, partnerships already have a formal structure for tracking the partner's ownership interest and capital contributions to the partnership—the partner's capital account. This account tracks the partner's capital contributions to the partnership, profits and losses earned by the partnership, and any distributions paid to the partner. Thus, the partnership capital account can serve as a reasonable measure of the amount of capital invested by the partner and the return to that investment.

The percentage change in the partner's capital account from one tax year to the next or calculated as an average of a set period could serve as the percentage of the partner's distribution that qualifies for the pass-through rate. Any remaining distribution would be taxed at individual rates.

Question 4: What Policies Should Be Included to Prevent Abuse and Simplify Administration of the Reformed Code?

Options for Preventing Abuse and Simplifying Administration

A significant disparity between the top individual rate and the pass-through rate will create strong incentives for owners to try to qualify as much income as possible for the pass-through rate. Therefore, in addition to the options discussed above, policymakers may want to include certain explicit limitations on taxpayers' ability to qualify income for the pass-through rate. They may also wish to adopt these policies as guards against abuse with the understanding that these policies may be stronger protection against abuse than the current rules—such as reasonable compensation

[15] Over the first two years in which the pass-through entity participates in this structure, the calculation would be performed only for the years actually recorded. For example, year one the percentage would be measured relative to the owner's starting basis. In year two, the change would be measured averaging years one and two.

rules—that have led to concerns about abuse of pass-through structures. Among other ideas, this can be accomplished by:

- Minimum or safe-harbor ratios of how much income could qualify for the pass-through rate;
- Caps on the annual return to capital for each year; or
- Maximum ratio for how much income could qualify for the pass-through rate.

Safe-Harbor Ratio

A minimum or a safe-harbor ratio could be established to determine how much income could qualify for the pass-through rate. For example, 90 percent of the income received by the owner could be taxed at the individual rate, and 10 percent of the income received by the owner could be taxed at the pass-through rate. The owner could opt instead to perform the calculations described in the previous section if that would provide a more beneficial tax result. By setting a default ratio that would deem at least some percentage of the income as eligible for the pass-through tax rate, the owner is guaranteed at least some recognition of return on "sweat equity" if there is no other capital investment made in the business. In addition, it would ensure that in a situation in which the value of the owner's share in the business declines, the owner can still qualify some income for the pass-through rate. A safe harbor also provides administrative simplicity for businesses, therefore obviating the need for the taxpayer to conduct the calculations.

Cap on Annual Return

Incorporating a cap on the percentage increase as it is calculated and applied in order to determine what share of income qualifies for the pass-through rate would serve as a limitation in situations where large percentage increases result from relatively large gains off a small base. The proposal could rely on existing provisions in the code, such as the long-term applicable federal rate (AFR). Today, the AFR ranges from X percent for short-term to Y percent for long-term investments. A formula to establish AFR plus a percentage (X) could be created.[16] Determining how much income qualifies for the pass-through rate would be the lower of the percentage calculated according to the asset-based approach described above, or AFR plus X.

Maximum Cap

An alternative or compliment to the minimum-ratio or safe-harbor concept would be to set a maximum, or cap, on the overall share of income that could qualify for the pass-through rate. For example, the maximum ratio could be set at 50/50, thereby establishing that a maximum of 50 percent of the income received by the owner could be taxed at the pass-through rate. If policymakers apply a maximum cap, they would need to consider whether the cap might be more generous than typical practice for S corporations when satisfying reasonable compensation requirements.

In addition, if policymakers provide more than one approach to the taxation of pass-through entities, they may wish to limit a business's ability to pick and choose what approach to adopt. Companies could be required to elect into one option and have such an election be permanent. Alternatively, policymakers could limit the number of times an entity could switch between options over any specified period of time.

Options for Extending Tax Concepts to Other Income

Finally, decision-makers will confront secondary issues that need to be addressed when deciding how to structure the new pass-through system. Among other items, this would include how to apply payroll taxes, carried interest, standard deductions for small businesses, and a myriad of related issues.

Application of Payroll Taxes

The proposed structures described above could be extended to determine what income is subject to FICA/SECA taxes. The proposal could apply FICA/SECA to all income subject to tax at individual tax rates (subject to the tax maximum for old age, survivor, and disability insurance, or "OASDI"). For S corporations in particular, this would expand the amount of income subject to payroll taxes. However, such a policy would largely address any concerns about abuse of the S corporation structure as a means to avoid SECA taxes. It would also significantly reduce the tax pressure on reasonable-compensation rules.

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[16] The applicable federal rate (AFR) is an interest rate determined by the IRS for income-tax purposes. There are three AFRs: short-term, mid-term, and long-term. *See* Internal Revenue Code 1274(d).

Application to Carried Interest

The underlying theory behind the asset-based option is that returns to capital should be taxed at business rates, not individual tax rates. The same theory can apply to carried interest. Thus, policymakers could extend the asset-based option and carried-interest profits. Some analysts have suggested that if the carry were subject to individual tax rates, the investors would be able to claim a deduction for the equivalent of wages paid to the service provider.[17]

Standard Deduction

For small pass-through businesses that already pay lower rates because they have low amounts of taxable income, base-broadening could result in a tax increase even if access to the lower rates is maintained. Therefore, policymakers should consider adding a "standard deduction" for pass-through businesses. Such a deduction could be designed to ensure that these pass-throughs do not experience a sharp and unintended tax increase. This deduction could be phased down as the amount of income that qualifies for the pass-through rate increases.

Other Issues

Integrating corporate tax reform with pass-through entities means tackling the various related policy issues that reflect the complexity of the current system and the challenges decision-makers must confront to protect the integrity of the system. As an example, the proposal could incorporate some existing S corporation tax-policy proposals, such as the existing rules that automatically terminate an S corporation when it has excessive passive income. Other changes could include making the time period for electing S corporation status line up with the deadline for filing S corporation taxes for that tax year; there could also be provisions that allow for an easier transition from C corporation to S corporation.

Similarly, the application of a new structure could impact partnerships. Various conforming changes could be made to partnership rules to ensure proper inclusion of capital contributions into the partner's capital account. Among such changes:

- Repeal provisions permitting guaranteed payments and liquidation distributions. Under this structure, such contributions would be included in the partner's capital account and included in the calculation to determine the segregation of income between individual and corporate tax rates.
- Extend current requirements for mandatory basis adjustments upon the transfer of any partnership interests within the partnership or the distribution of property to a partner.
- Ensure proper tracking of any built-in gain in property contributed by a partner to the partnership.
- Ensure that partnership interests provided as a gift to a partner are excluded from the partner's capital account.
- In order to prevent the unintended termination of the partnership when capital in the partnership is transferred, the proposal could repeal the existing rule that would terminate partnerships when 50 percent or more of the capital in the partnership is sold or is exchanged in any 12-month period.

Conclusion

Tax reform is inherently difficult. It is not only intricate, with myriad potential interactions, but it also affects virtually every American. Accordingly, it requires policymakers to weigh an array of potentially competing priorities and goals.

The paramount mission for policymakers should be to develop a business tax code that is seen as fair and equitable in its treatment of businesses both large and small, and to provide the incentives for individuals to become entrepreneurs who will, in turn, create jobs and economic growth. This approach is vital with respect to reforming the tax treatment of pass-through entities. Policymakers must resolve concerns about raising taxes on pass-through businesses while also ensuring that any new rules or structures do not become an avenue of abuse. The options presented in this paper reflect the breadth of issues, challenges, and potential paths forward that policymakers should consider when wrestling with this crucial and complex undertaking.

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[17] Donald Marron, *Goldilocks Meets Private Equity: Taxing Carried Interest Just Right,* Tax Policy Center, Urban Institute and Brookings Institution, October 6, 2016. Available at: *http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000956-Goldilocks-Meets-Private-Equity-Taxing-Carried-Interest-Just-Right.pdf.*

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

Let me begin by saying that everybody here is wishing Senator McCain a full and speedy recovery from his recent surgery. John McCain is tougher than just about anybody out there, so I'm sure he'll be back in these halls soon.

It is hard to imagine a member of Congress, Republican or Democrat, who would stand up before a crowd at a business or town hall meeting at home and say, "I'm a big fan of the tax system on the books." Insanely complicated, riddled with sweetheart deals, and plagued by the inversion virus, I don't find many members of Congress who argue for the tax status quo.

What's needed is bipartisan tax reform that focuses on progressivity, helping the middle class, cleaning out flagrant tax loopholes, fiscal responsibility, and giving everybody in America the chance to get ahead. In short, bipartisan tax reform would build on key principles that brought Democrats and Republicans together for major bipartisan tax reform slightly more than 3 decades ago.

Unfortunately, in the first months of this administration, the majority party has not shown any interest in such an approach. Before his confirmation, Secretary Mnuchin debuted the Mnuchin Rule—no absolute tax cut for the wealthy. In my view, it's fair to say that stirred quite a bit of interest on this side of the aisle. But it wasn't long before Secretary Mnuchin and the Trump economic team were making a full-scale retreat from that principle.

The administration's one-page plan of tax reform bullet points gave the fortunate few a lot of detail about how their taxes would be cut. Not so for working Americans and the middle class. In fact, independent analyses said millions of working Americans were in line for a tax increase under the Trump plan. Furthermore, in the last few weeks, the Treasury Department has begun to wipe out tax rules designed to crack down on corporate inversions, protect jobs and close estate tax loopholes. But without a plan waiting in the wings to replace those rules, that means the Treasury Department is risking a new outbreak of the inversion virus, putting jobs at risk, and condoning tax avoidance.

Here in Congress, there are widely circulated pictures of a meeting of a group called the "Big Six" comprised entirely of Republican Senators, Representatives, and Trump officials. Republican members have already telegraphed a plan to transplant the Trumpcare tax breaks for the wealthy into a big, regressive tax cut package later this year. And majority leadership in the Senate has signaled that they plan to move tax legislation with the same my-way-or-the-highway approach called reconciliation they're using to force a vote on Trumpcare. It's hard to look at that evidence and find any proof that the majority party wants real Democratic involvement in tax reform.

Anybody can write a bill that slashes tax rates for the fortunate few and the biggest corporations, and it might even get enough support to become law. It's not a great way to provide certainty and predictability needed to create good-paying jobs and expand economic opportunity, but it is a great way to create tax windfalls for the wealthy.

I've written two comprehensive, bipartisan tax reform bills, and the core principle that I brought to both was that tax reform needed to give everybody a chance to get ahead.

That only happens with a tax system that retains the progressivity that has been the hallmark of all modern tax reforms. Tax reform that drives economic growth by putting money in the pockets of wage-earning Americans only works if tax reform is lasting and bipartisan. I look forward to hearing from our witnesses today about how lessons from past tax debates could help promote real bipartisan tax reform today.

Finally, there is one last issue that needs to be raised this morning. There's no question that tax reform is an important subject. But the dominant business before the Senate for the last several weeks has been health care. And now the partisan approach to jam through a bill that raises premiums, hurts those with pre-existing conditions, and slashes Medicaid has failed for a second time. This ought to be a sign that Trumpcare just isn't the answer, that repealing the ACA isn't the answer, and that the majority should work with Democrats on the big health-care challenges facing the country.

COMMUNICATIONS

AIR CONDITIONING CONTRACTORS OF AMERICA, ET AL.

August 1, 2017

The Honorable Orrin Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

Dear Chairman Hatch and Ranking Member Wyden:

We write to thank the Senate Committee on Finance for holding a hearing on "Comprehensive Tax Reform: Prospects and Challenges" on July 18, 2017. Our companies and organizations share the common goal of pursuing tax reforms that will grow our economy and create jobs. To that end, we welcome the opportunity to highlight the positive contributions of tax incentives for energy efficient investment. In particular, the Section 179D tax deduction for energy efficient commercial and larger multifamily buildings has leveraged billions of dollars in private capital, resulted in energy efficient enhancements to thousands of buildings, and created and preserved hundreds of thousands of jobs since its inception. Reforms to Section 179D can boost these economic fundamentals even more.

These benefits are confirmed by a recent economic impact study conducted by Regional Economic Models, Inc. ("REMI"), the executive summary of which is attached to this statement as an appendix. REMI's conclusion is unequivocal, finding that "Section 179D is an engine of economic and employment growth." In particular, an enhanced tax incentive for energy-efficient commercial buildings, including reforms geared toward retrofits of privately owned buildings, could support up to 76,529 jobs and contribute almost $7.4 billion toward our national GDP each year. These results represent a significant return on the taxpayer investment in Section 179D, well in excess of the provision's revenue cost.

The study also confirms that extending the current version of Section 179D or making more modest changes to the incentive would have a substantial positive impact on economic and employment growth.

We urge you to keep the economic impact of Section 179D in mind as you consider comprehensive tax reform. Section 179D's proven ability to support economic growth and job creation aligns with the Committee's goals for tax reform. We look forward to working with you to ensure that tax incentives for energy efficient investment continue to be an engine of growth for our economy. Thank you for your consideration.

Sincerely,

Air Conditioning Contractors of America
Alliantgroup, LLC
Ameresco
American Council of Engineering Companies
American Institute of Architects
American Society of Interior Designers (ASID)
APPA—Leadership in Educational Facilities
BLUE Energy Group
Building Owners and Managers Association (BOMA) International
CCIM Institute
Concord Energy Strategies
Consolidated Edison Solutions

Daikin US Corporation
E2 (Environmental Entrepreneurs)
Energy Optimizers, USA
Energy Systems Group
Energy Tax Savers, Inc.
Entegrity
Green Business Certification Inc.
Institute of Real Estate Management
Insulation Contractors Association of America
Johnson Controls, Inc.
Lexicon Lighting Technologies
LightPro Software, LLC
LuNex Lighting
Micromega Systems, Inc.
National Apartment Association
National Association of College and University Business Officers (NACUBO)
National Association of Electrical Distributors
National Association of Energy Service Companies (NAESCO)
National Association of Real Estate Investment Trusts (NAREIT)
National Association of State Energy Officials (NASEO)
National Electrical Manufacturers Association (NEMA)
National Multifamily Housing Council
National Association of REALTORS®
National Roofing Contractors Association
OpTerra Energy Services
Plumbing-Heating-Cooling Contractors—National Association
Polyisocyanurate Insulation Manufacturers Association (PIMA)
PowerDown Holdings, Inc.
PowerDown Lighting Systems, Inc.
Rampart Partners LLC
The Real Estate Roundtable
Sheet Metal and Air Conditioning Contractors' National Association (SMACNA)
Sustainable Performance Solutions LLC
U.S. Green Building Council

Analysis of Proposals to Enhance and Extend the Section 179D Energy Efficient Commercial Buildings Tax Deduction

Prepared by Regional Economic Models, Inc. (REMI), May 2017

Executive Summary

Section 179D of the Internal Revenue Code, the Energy Efficient Commercial Buildings Deduction, was originally enacted by Congress as part of the Energy Policy Act of 2005 to promote energy independence. Section 179D promotes the proper allocation of incentives in the real estate development process. A key challenge to realizing the benefits of energy-efficient improvements is that the associated cost savings flow to building occupants, not developers. By helping offset the cost of energy efficient investments, Section 179D allows building owners to share in the incentive to install energy-efficient improvements that help their occupants save money on electricity, water, and climate control costs. In so doing, Section 179D promotes private-sector solutions to improve conservation practices and modernize national infrastructure.

In this analysis, REMI evaluates the economic impact of three potential approaches to the Section 179D deduction, which most recently expired at the end of 2016:

1. **Strengthening and Modernizing Section 179D,**[1] which would increase the value of the deduction to $3.00 per square foot from $1.80, increase the applicable energy efficiency standards, make it available to support improvements to existing as well as new buildings, and extend the deduction.

[1] Proposals along these lines include Title I of S. 2189, sponsored by Senator Cardin (D–MD) in the 113th Congress and the President's FY 2017 Budget Proposal. *See* "Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2017 Budget Proposal," Joint Committee on Taxation, July 2016, JCS–2–16.

2. **Extension of Current Law Section 179D Plus Expansion to Non-Profits and Tribal Governments,**[2] modeled on 2015 legislation developed by the Senate Finance Committee under Chairman Orrin Hatch (R–UT), which would extend the deduction, expand availability of the deduction to nonprofit organizations and tribal governments and increase the applicable energy efficiency standards.
3. **Extension of Current Law Section 179D,**[3] modeled on the two-year extension of current law enacted as part of the Protecting Americans from Tax Hikes ("PATH") Act of 2015.

The results of this analysis show that in addition to advancing the goal of energy independence, Section 179D is an engine of economic and employment growth. As captured in the table below, this study quantifies these impacts, finding that:

- Strengthening and extending the Section 179D Energy-Efficiency Commercial Buildings Deduction will create jobs and expand the nation's economy. These benefits would be compounded by increasing the dollar value of the deduction in accordance with several Congressional and administration proposals.
- These enhancements to Section 179D would support up to 76,529 jobs annually and contribute annually almost $7.4 billion to national gross domestic product ("GDP"), as well as over $5.7 billion towards national personal income.
- Expanding the availability of the deduction to nonprofit organizations and tribal governments, while increasing the applicable energy efficiency standards, also provide clear positive impacts to the economy.

Table 1. Average Annual Economic Impacts for First 10 Years

	Strengthen and Modernize	Extension Plus Expansion	Extension of Current Law
Jobs	76,529	39,388	40,749
GDP (millions of dollars)	7,398	3,730	3,860
Personal income (millions of dollars)	5,729	3,017	3,128

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This Statement is submitted by American Citizens Abroad, Inc. and American Citizens Abroad Global Foundation.

Congress should reform the Internal Revenue Code and it should do so as soon as possible. In the area of international tax provisions, at the same time it modernizes the rules applicable to U.S. corporations with foreign earnings and foreign subsidiaries and other operations, among other things adopting "territorial" tax principles, similarly it should apply "territorial" tax principles broadly to individuals.

"Territoriality" for corporations, as this Committee knows well, means that U.S. corporations, which are currently taxed, in general, on their worldwide income regardless where the income is earned, would be taxed only on income earned in the U.S. Under current rules, corporations benefit from partial territoriality in the sense that foreign subsidiaries organized and operated in highly circumscribed ways can defer U.S. tax. As for individuals, at present, they are taxed on their worldwide income regardless where they reside. Taxpayers meeting stringent residency-abroad tests,

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[2] *See* "Description of the Chairman's Mark of a Bill to Extend Certain Expired Tax Provisions," July 17, 2015, JCX–101–15, and "Description of the Chairman's Modification to the Chairman's Mark of a Bill to Extend Certain Expired Tax Provisions," July 21, 2015, JCX–103–15. In addition to the Senate Finance Committee extenders bill, other proposals along these lines include H.R. 6376, sponsored by Congressman Reichert (R–WA) in the 114th Congress.

[3] "General Explanation of Tax Legislation Enacted in 2015," Joint Committee on Taxation, March 2016, JCS–1–16.

that is, they truly reside outside the U.S. and do so not just for short periods of time, are entitled to a form of partial territoriality in that they can exclude a portion of their foreign earned income, but not other types of income, and perhaps deduct some foreign housing costs.

Territorial tax treatment of individuals equates to taxation on a residency basis, according to where you reside, as opposed to taxation on a citizenship basis, that is, due solely to the fact that you are a U.S. citizen.

Congress should amend the tax rules applicable to individuals residing abroad, making them taxable only on U.S. source income and income connected with the U.S. business or otherwise connected with the U.S. These rules would only apply to Americans truly residing abroad, not to Americans residing in the U.S.[1]

There are an estimated 9 million Americans living overseas. Many have lived there all their lives. They may have moved abroad after meeting their foreign spouse or partner or attending school or finding a job. They may have been born to non-U.S. citizens only temporarily in the U.S., for example, studying—well obviously not just studying—at a U.S. university. Based on 2014 census figures, if grouped like a state, Americans abroad would be the 11th largest state, just ahead of New Jersey and Virginia. Due to voting rules, however, they do not vote as a block. Rather their votes are mostly disbursed among the 50 states where they last lived or where their parents last lived.

American citizens, since the Civil War and without interruption since 1913, like corporations, have been taxed on their worldwide income, regardless where they reside or where the income arises. This rule was initially intended to catch individuals who dodged the draft or otherwise shirked their duties to the Union. Since 1926, however, a version of partial "territoriality" for individuals has permitted Americans residing abroad to not pay tax on limited amounts of foreign earned income and foreign housing costs. These rules are tortured and have been amended many times—17 times just since 1962.

As things stand, the U.S. is wildly out of sync with the rest of the world in the way it taxes individuals residing outside the country. It is the only country other than war-torn and impoverished Eritrea that taxes individuals based on their citizenship. An American citizen who, for example, has resided outside the U.S. all her life, who owns no property in the U.S. and who earns no U.S. source income, is required to file returns and pay U.S. taxes the same as someone living in St. Louis. The fact that she also pays tax to the country where she resides makes no difference. And because the U.S. does not have tax treaties with most countries, and many existing tax treaties are outdated, the goal of avoiding double taxation of income is often not completely achieved. A clear example is the 3.8% Net Investment Income Tax, enacted in combination with the Affordable Care Act 2010, which cannot be offset by foreign tax credits; thus, income can be taxed once by the foreign country where the individual resides in a second time by the U.S.

The tax rules and forms confronting the American citizen living overseas are mind-boggling, and the penalties for incorrect reporting or, more likely, simply not understanding the rules, can be financially ruinous. It's very difficult for taxpayers to prepare their own tax return. The forms for claiming exclusions and foreign tax credits and to report foreign financial assets are extremely challenging. A typical tax return for a relatively simple financial situation can easily run 75 to 100 pages and much more for self-employed individuals and small business owners.

Only around 450,000 taxpayers, based on most recent figures, claimed the foreign earned income exclusion, which is the tax provision designed to help them. Many more, close to 4 million, claimed foreign tax credits. It is estimated, based on projections for 2018 that the exclusion, in saved taxes, was worth about $7 billion. Savings due to the foreign tax credit are generally not viewed as a tax expenditure because the credit is simply a way of avoiding patently unfair double taxation.

Now's the time to correct this indefensible incongruity. With the concept of "territoriality" on the table with respect to corporate tax law changes, the concept and its workings are on everyone's mind. A change for individual scan be made easily, without major surgery on the Internal Revenue Code. Simply put, Americans abroad would be treated essentially the same as foreign individuals. It follows, they would remain taxable on U.S.-source income. This is the same approach used by all other

[1] Americans residing in the U.S. who are shareholders in foreign corporations may benefit from changes in the rules for taxing these and similar foreign entities.

developed countries. Moreover, it might be achieved without a loss of tax revenue. Loopholes can be guarded against with super strict drafting.

Problems associated with FATCA that today plague Americans abroad, such as the problem of "lockout" foreign financial institutions, would largely go away. An American citizen residing abroad would no longer be treated as a U.S. account holder for FATCA purposes. Foreign banks would no longer need to be wary of providing services to this individual. Also, the problems of enforcing tax and foreign account reporting rules against Americans overseas could be reassessed. These individuals would be incentivized to bring themselves into compliance. There would be the need to chase after them and employ complicated and sometimes unfair disclosure and other enforcement programs.

The amount of tax revenue involved, by any estimate, is minimal—less than the cost of running the Federal Government for one day. With thoughtful choices about the design of the new rules and transition provisions, the cost might be reduced to nil. In fact, taking into consideration reasonable assumptions concerning improved compliance and without "cooking the books," the overall revenue effect might be slightly positive.

Residency-based taxation would translate into more jobs for Americans and more exports of American goods and services around the world. As it stands, the tax code encourages U.S. businesses to expand and earn profits globally, but to do so without hiring U.S. citizens, who due to citizenship-based taxation can cost 2 to 3 times the amount of hiring a non-American. Congress should act strategically to encourage more Americans to live and work overseas. An enormous ambassadorial force would be created, which would encourage the purchase of American goods and services.

Small businesses would no longer face the problem of hiring Americans to work and market their products abroad. Larger exporters would save the costs of employing Americans abroad and having to incur the costs of equalizing their after-tax compensation and paying for the accounting and return preparation costs associated with this.

There is a wide range of plans for reforming corporate taxes, but all of them include some form of "territoriality." House Republicans have developed a "blueprint" for tax reform that adopts a territorial approach for corporations and quite deliberately presents the possibility of changes for individuals. On the Senate side, Chairman Hatch's 2014 corporate integration proposal called for reconsideration of the taxation of nonresident citizens. Treasury Department and the White House, in the recently proposed 2018 budget, expressed interest in transitioning to a territorial system.

Residency-based taxation for American citizens residing abroad fits comfortably alongside all the international tax reform proposals being developed, and importantly it can attract bipartisan support at a time when many would like to see more of this sort of thing. *While differing on some details, Democrats Abroad, Republicans Overseas, Americans for Tax Reform, the Heritage Foundation, American Citizens Abroad, a number of American Chambers of Commerce overseas, and other business groups, all support changing from citizenship-based taxation to a residency-based taxation approach.*

ACA submits the time is now for the Congress to take a strategic approach to its tax policy for its citizens residing abroad. Well-crafted legislation will result in increased employment of Americans, decreased costs to the government, simplification of the tax code, and a re-invigorated American diaspora to promote America's goods and services around the world. Whoever champions this cause not only will become the patron saint of Americans abroad but will help expand America's workforce and economy.

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INTRODUCTION

The American Institute of CPAs (AICPA) applauds the leadership taken by the Senate Committee on Finance for considering comprehensive tax reform that examines

all aspects of the Internal Revenue Code (IRC or "Tax Code") to simplify the tax system and make tax rules more understandable and accountable.

The proliferation of new income tax provisions since the Tax Reform Act of 1986 has led to compliance hurdles for taxpayers, enforcement challenges for the Internal Revenue Service (IRS or "Service") and administrative complexity for taxpayers and practitioners. The consequence of noncompliance, resulting in the tax gap, is estimated at $458 billion per year.[1] Additionally, trust in the tax administration system and a sense of fairness is lost by taxpayers trying to keep up with the changing tax landscape. To help alleviate these challenges and promote principles of good tax policy, we offer suggestions on how to address the prospects and challenges of comprehensive tax reform.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

GOOD TAX POLICY

First, we should consider the features of an ideal tax system. The AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification and other principles of good tax policy[2] as explained in a report we recently updated and issued.[3] Our tax system must be administrable, support economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations.

We think these features are achievable if the following 12 principles of good tax policy are considered in the design of the system:

- Equity and fairness
- Convenience of payment
- Information security
- Neutrality
- Transparency and visibility
- Accountability to taxpayers
- Certainty
- Effective tax administration
- Simplicity
- Economic growth and efficiency
- Minimum tax gap
- Appropriate government revenues

Our profession has long-advocated for a transparent tax system. For example, we urge Congress to use a consistent definition of taxable income without the use of phase-outs. Provisions, such as phase-out rules, that limit or eliminate the use of certain deductions and exclusions for those taxpayers in higher tax brackets, perpetuate the flaws of the current system, leading to nontransparent tax results and increased complexity. These rules also create marginal rates in excess of the statutory tax rate. In addition, multiple tax regimes (such as the alternative minimum tax (AMT), which applies in addition to the regular income tax) make it almost impossible for taxpayers to easily know their effective and marginal tax rates. We urge Congress to use tax reform as an opportunity to remove phase-outs and multiple tax regimes, and develop the best definition of taxable income by creating simple, transparent, tax rules applied consistently across all rate brackets.

We also urge you to make tax provisions permanent. For many taxpayers, individuals and businesses alike, uncertainty in the Tax Code creates unnecessary confusion and anxiety. Complexity can also result in taxpayers not taking full advantage of provisions intended to help them, resulting in higher taxes and greater compliance costs. While our Tax Code has always had a tendency to change, in recent years the rate of change has accelerated. Statutory changes result in new regulations, revenue procedures, notices and new or modified tax forms which take time and resources to understand and address. Taxpayers need a Tax Code that is simple, transparent, and certain.

AICPA PROPOSALS

In the interest of good tax policy and effective tax administration, we appreciate the opportunity to address the following issues:

1. Cash method of accounting

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[1] IRS, "The Tax Gap," April 4, 2017.

[2] AICPA concept statement, "Tax Policy Concept Statement 1, Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals," January 2017.

[3] For an explanation of why and how the AICPA principles of good tax policy were updated, *see* "Tax Principles for the Digital Age," May 1, 2017.

2. Tax rates for pass-through entities
3. Distinguishing compensation income
4. Interest expense deduction
5. Definition of "compensation"
6. Mobile workforce
7. Retirement plans
8. Civil tax penalties
9. IRS taxpayer services
10. IRS deadline related to disasters
11. Emerging issues

1. Cash Method of Accounting

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting.[4] The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the related income. Therefore, entrepreneurs often choose this method for small businesses.

We are concerned with, and oppose, any new limitations on the use of the cash method for service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as partnerships and S corporations. Requiring businesses to switch to the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth.[5]

The AICPA believes that limiting the use of the cash method of accounting for service businesses would:

a. Discourage natural small business growth;
b. Impose an undue financial burden on their individual owners;
c. Increase the likelihood of borrowing;
d. Impose complexities and increase their compliance burden; and
e. Treat similarly situated taxpayers differently (because income is taxed directly on their owners' individual returns).

Congress should not further restrict the use of the long-standing cash method of accounting for the millions of United States (U.S.) businesses (*e.g.,* sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method.

2. Tax Rates for Pass-through Entities

If Congress, through tax reform, lowers the income tax rates for C corporations, all business entity types should receive a rate reduction. The majority of businesses are structured as pass through entities (such as, partnerships, S corporations, or limited liability companies).[6] Tax reform should not disadvantage these entities or require businesses to engage in complex entity changes to obtain favored tax status.

Congress should continue to encourage, or more accurately—not discourage, the formation of pass-through entities as these business structures provide the flexibility and control desired by many business owners that is not available within the more formal corporate structure. Entrepreneurs generally do not want to create entities that require extra legal obligations (such as holding annual meetings of a board of directors). They prefer business structures that are simple and provide legal and tax advantages.

3. Distinguishing Compensation Income

If Congress provides a reduced rate for active business income of sole proprietorships and pass-through entities, we recognize that it will place additional pressure on the distinction between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by using traditional definitions of "reasonable compensation" supplemented, if necessary, by additional guidance from the U.S. Department of the Treasury.

We encourage Congress to consider codifying the existing judicial guidance on the definition of reasonable compensation that reflects the type of business (for example,

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[4] AICPA letter, "Investment in New Ventures and Economic Success Today Act of 2017 (S. 1144)," June 22, 2017.

[5] A required switch to the accrual method affects many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

[6] *See* Census Bureau, "County Business Patterns;" Census Bureau, "Nonemployer Statistics."

labor versus capital intensive), the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles).

Reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, Congress should direct the IRS to take additional steps to improve compliance and administration in this area. For example, a worksheet maintained with the taxpayer's tax records would allow businesses to indicate the factors considered in determining compensation in a reasonable and consistent manner.

Changes to payroll tax rules, such as a requirement for partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes, will also facilitate compliance for small businesses. We suggest that partners and proprietors are not treated as "employees," but rather owners subject to withholding—a new category of taxpayer—similar to a partner with a guaranteed payment for services. Similar rules requiring reasonable compensation currently exist in connection with S corporations. The broader inclusion of partners and proprietors in more well-defined compensation rules should facilitate and enhance the development of appropriate regulations and enforcement in this area.

There are advantages to using a reasonable compensation approach for owners of all business types, including:

a. Fairness that respects the differences among business types and owner participation levels;
b. A reduced reliance by taxpayers and the IRS on quarterly estimated tax payments;
c. Diminished reliance on the self-employment tax system; and
d. Simplification due to uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation and personal service corporation areas) to provide regulatory and judicial guidance.

In former Ways and Means Committee Chairman Dave Camp's 2014 discussion draft,[7] a proposal was included to treat 70% of pass-through income of an owner-operator as employment income. While this proposal presents a simple method, it would result in an inequitable result in many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend making the proposal a safe harbor option. For example, the proposal must make clear that the existence and the amount of the safe harbor is not a maximum amount permitted but that the reasonable compensation standard utilized for corporations will remain available to taxpayers. These rules will provide a uniform treatment among closely held business entity types. Appropriate recordkeeping, when the safe harbor option is not used, would also address the enforcement challenges currently faced by the IRS.

4. Interest Expense Deduction

Another important issue for small businesses, as well as professional service firms, is the ability to deduct their interest expense. New business owners incur interest on small business loans to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and to build credit for future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (such as to the extent of interest income) would effectively eliminate the benefit of a valid business expense for many small businesses, as well as many professional service firms. If a limit on the interest expense deduction is paired with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering larger manufacturers, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to $510,000 of acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal[8] under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment in the first year. How-

[7] H.R. 1 (113th Congress), The Tax Reform Act of 2014, Section 1502; *also see* Section-by-Section Summary, pages 32–33.

[8] House Republican's Tax Reform Task Force Blueprint, "A Better Way: Our Vision for a Confident America," June 24, 2016.

ever, since small businesses do not usually purchase large amounts of new assets, this proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only takes away an important deduction for many businesses who are forced to rely on debt financing to cover their operating and expansion costs.

We suggest allowing small (and perhaps "mid-size") businesses to continue to deduct net interest expense. Given the reliance on this deduction and the importance to the economy, we would also suggest allowing all businesses (except for the large manufacturers, retailers and other asset intensive businesses which will benefit the most from the immediate expensing of all equipment) to continue to deduct net investment interest.

5. Definition of "Compensation"

Tax reform discussions have considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct.

We are concerned, particularly from a small business perspective, about any decrease of an employer's ability to deduct compensation paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the Tax Code would substantially impact the small and labor-intensive businesses' ability to build and retain a competitive workforce.

6. Mobile Workforce

The AICPA supports the Mobile Workforce State Income Tax Simplification Act of 2017, S. 540, which provides a uniform national standard for non-resident state income tax withholding and a *de minimis* exemption from the multi-state assessment of state non-resident income tax.[9]

The current situation of having to withhold and file many state nonresident tax returns for just a few days of work in various states is too complicated for both small businesses and their employees. Businesses, including small and family businesses that operate interstate, are subject to a multitude of burdensome, unnecessary and often bewildering non-resident state income tax withholding rules. These businesses struggle to understand and keep up with the variations from state to state. The issue of employer tracking and complying with all the different state and local tax laws is quite complicated and costly. The documentation takes a lot of time, not to mention the loss in economic productivity for small businesses.

S. 540 would provide long-overdue relief from the current web of inconsistent state income tax and withholding rules on nonresident employees. Therefore, we urge Congress to pass S. 540 that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

7. Retirement Plans

Small businesses are burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and Savings Incentive Match Plan for Employees (SIMPLE) plans. Having four variations of the same plan type causes confusion for many plan participants and small businesses. A suggested approach is to eliminate SIMPLE Individual Retirement Accounts (IRAs) and amend the rules of Simplified Employee Pensions (SEPs) to allow for salary reduction contributions, as previously permitted. In addition, Congress could eliminate the SIMPLE 401(k) plan because while the fees are similar to that of a 401(k) plan, the 401(k) is more flexible.

We also propose eliminating the top-heavy rules because they constrain the adoption of 401(k) plans and other qualified retirement plans by small employers. Since the top-heavy rules were enacted in 1982, there have been a number of statutory changes which have made the need for separate top-heavy rules unnecessary. The existing discrimination rules for retirement plans ensure that non-highly compensated employees receive nondiscriminatory benefits, such that the top-heavy rules often do not increase benefits in a meaningful way. In addition, the annual contribution limitations ensure that no employee's benefits are excessive.

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[9] For additional details, *see* AICPA written statement, AICPA statement for the record of the April 13, 2016 hearing on "Keep it Simple: Small Business Tax Simplification and Reform, Main Street Speaks," April 7, 2016.

8. Civil Tax Penalties

Congress should carefully draft penalty provisions and the Administration should fairly administer the penalties to ensure they deter bad conduct without deterring good conduct or punishing innocent taxpayers (*i.e.,* unintentional errors, such as those who committed the inappropriate act without intent to commit such act). Targeted, proportionate penalties that clearly articulate standards of behavior and are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws. On the other hand, overbroad, vaguely-defined, and disproportionate penalties create an atmosphere of arbitrariness and unfairness that can discourage voluntary compliance.

The AICPA has concerns about the current state of civil tax penalties and offers areas [10] for improvement, including the following key issues:

Trend Toward Strict Liability

The IRS discretion to waive and abate penalties where the taxpayer demonstrates reasonable cause and good faith is needed most when the tax laws are complex and the potential sanction is harsh. Legislation should avoid mandating strict liability penalties. Over the past several decades, the number of increasingly severe civil tax penalties have grown, with the Tax Code currently containing eight strict liability penalty provisions (for example, the accuracy penalty on non-disclosed reportable transactions).[11]

An Erosion of Basic Procedural Due Process

Taxpayers should know their rights to contest penalties and have a timely and meaningful opportunity to voice their feedback before assessment of the penalty. In general, this process would include the right to an independent review by the IRS Appeals office or the IRS's FastTrack appeals process, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.

9100 Relief

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who inadvertently miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list [12] of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities.

9. IRS Taxpayer Services

Whether addressed within or outside of tax reform, we urge Congress to address IRS taxpayer services, and recommend that any effort to modernize the IRS and its technology infrastructure should build on the foundation established by the Report of the National Commission on Restructuring the IRS ("Restructuring Commission").

As tax professionals, we represent one of the IRS's most significant stakeholder groups.[13] As such, we are both poised and committed to being part of the solution for improving IRS taxpayer services. In March, we submitted a letter [14] to House Ways and Means Committee and Senate Finance Committee members in collaboration with other professional organizations. Our recommendations include modernizing IRS business practices and technology, re-establishing the annual joint hearing review, and enabling the IRS to utilize the full range of available authorities to hire and compensate qualified and experienced professionals from the private sector to meet its mission. The legislative and executive branches should work together to de-

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[10] *See* AICPA white paper, "AICPA Tax Penalties Legislative Proposals," April 2013; and the "AICPA Report on Civil Tax Penalties," April 2013.

[11] Sections 6662A, 6664(d).

[12] AICPA letter, "Tax Reform Administrative Relief for Various Statutory Elections," January 23, 2015.

[13] Sixty percent of all e-filed returns in 2016 were prepared by a tax professional, according to the Filing Season Statistic for Week Ending December 2, 2016.

[14] AICPA letter, "Ensuring a Modern-Functioning IRS for the 21st Century," April 3, 2017.

termine the appropriate level of service and compliance they want the IRS accountable for and then dedicate appropriate resources for the Service to meet those goals.

To enable the IRS to achieve the improvements required for a 21st-century tax administration system, the IRS needs a modern technological infrastructure. Currently, the IRS has two of the oldest information systems in the federal government making the information technology functions one of the biggest constraints overall for the IRS.[15] Without modem infrastructure, the IRS is unable to timely and efficiently meet the needs of taxpayers and practitioners.

Additionally, we recommend the IRS create a new dedicated practitioner services unit to rationalize, enhance, and centrally manage the many current, disparate practitioner-impacting programs, processes, and tools. Enhancing the relationship between the IRS and practitioners would benefit both the IRS and the millions of taxpayers, including small businesses, served by the practitioner community. As part of this new unit, the IRS should provide practitioners with an online tax professional account with access to all of their clients' information. The IRS should also offer robust practitioner priority hotlines with higher-skilled employees that have the experience and training to address complex issues. Furthermore, the IRS should assign customer service representatives (a single point of contact) to geographic areas in order to address challenging issues that practitioners could not resolve through a priority hotline.

10. IRS Deadlines Related to Disasters

Similar to IRS's authority to postpone certain deadlines in the event of a presidentially declared disaster, Congress should extend that limited authority to state-declared disasters and states of emergency. Currently, the IRS's authority to grant deadline extensions, outlined in section 7508A, is limited to taxpayers affected by federal-declared disasters. State governors will issue official disaster declarations promptly but often, presidential disaster declarations in those same regions are not declared for days, or sometimes weeks after the state declaration. This process delays the IRS's ability to provide federal tax relief to impacted businesses and disaster victims. Taxpayers have the ability to request waivers of penalties on a case-by-case basis; however, this process causes the taxpayer, tax preparer, and the IRS to expend valuable time, effort, and resources which are already in shortage during times of a disaster. Granting the IRS specific authority to quickly postpone certain deadlines in response to state-declared disasters allows the IRS to offer victims the certainty they need as soon as possible.

The AICPA has long supported a set of permanent disaster relief tax provisions[16] and we acknowledge both Congress's and the IRS's willingness to help disaster victims. To provide more timely assistance, however, we recommend that Congress allow the IRS to postpone certain deadlines in response to state-declared disasters or states of emergency.

11. Emerging Issues

Online crowdfunding and the sharing economy are quickly expanding mediums through which individuals obtain funds, seek new sources of income, and start and grow businesses. Individuals may understand the steps through which they can use these new crowdfunding and sharing economy opportunities to their advantage. However, many small businesses do not have the guidance necessary to accurately comply with the complex, out-of-date, or incomplete tax rules in these emerging areas.

Lawmakers and tax administrators must regularly review existing laws, against new changes in the ways of living and doing business, to determine whether tax rules and administration procedures need modification and modernization. We urge Congress and the IRS to develop simplified tax rules and related guidance in the emerging sharing economy and crowdfunding areas.[17] Some of the areas in need of modernization include information reporting (such as to avoid reporting excluded income, such as a gift as income), simplicity in reporting and tracking rental losses from year to year, and simplified approaches for recordkeeping for small businesses.

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[15] National Taxpayer Advocate, *Annual Report to Congress 2016. Executive Summary: Preface, Special Focus and Highlights,* 2016, pp. 31–32. The report references a 2016 GAO report (GAO–16–468) which found that some of technology the IRS currently uses was placed in service 56 years ago.

[16] AICPA letter, "Request for Permanent Tax Provisions Related to Disaster Relief," November 22, 2013.

[17] AICPA written statement, "The 2017 Filing Season: IRS Operations and the Taxpayer Experience," April 6, 2017.

Offering clarity on these issues will allow taxpayers to follow a fair and transparent set of guidelines while the IRS benefits from a more efficient voluntary tax system.

CONCLUDING REMARKS

As Congress tackles the complex issues inherent in drafting tax legislation, we encourage you to consider tax reform that will provide simplicity, certainty and clarity for taxpayers. The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will reduce taxpayers' compliance costs and encourage voluntary compliance through an understanding of the rules. The AICPA appreciates the opportunity to submit this written testimony and we look forward to working with the Committee as you continue to address comprehensive tax reform.

BIOMASS POWER ASSOCIATION
601 New Jersey Avenue, NW, Suite 660
Washington, DC 20001

July 17, 2017

Senate Committee on Finance
Dirksen Senate Office Building
Washington, DC 20510–6200

Re: July 18, 2017 Senate Finance Committee hearing on "Comprehensive Tax Reform: Prospects and Challenges"

Chairman Hatch, Ranking Member Wyden, and members of the committee:

The Biomass Power Association provides the following joint statement for the record on how federal tax policy impacts the growth opportunities and project deployment in our sectors.

We recently submitted comments to you as part of a larger group of renewable baseload power sources, including hydropower, waste-to-energy and biogas. Like many of our baseload renewable energy colleagues, the biomass power industry is struggling in the marketplace for new electricity generation as a result of being placed at a significant competitive economic disadvantage vis-à-vis wind and solar electricity by the long-term tax credit extensions provided to those technologies in 2015, while incentives for our industries were allowed to expire at the end of 2016.

We represent standalone power facilities that use as fuel primarily organic residues and byproducts. Our 40 members operate in 21 states, typically where there is a thriving forestry or agriculture industry nearby. Biomass power facilities in the United States purchase "leftovers" like forestry residues; orchard and other agricultural prunings; hulls from rice, nut and oat production; construction and demolition waste; and unusable wood from sawmills. The fuels used by our domestic industry usually have no higher value. If left unused by biomass power facilities, these fuels would be left on the forest floor, sent to a landfill, or openly burned for disposal.

As we stated in our previous letter to you, baseload renewables including biomass should be at the forefront of discussions on low-cost, clean energy development. The fuels used by biomass power facilities typically come from within a 50–75 mile radius, rather than being imported from elsewhere, supporting the local economy. In the area where a biomass facility is located alongside other wood products manufacturers, loggers have an additional outlet for materials they harvest. Biomass fuel can account for up to 30% of a logger's revenue—a significant amount that has helped keep some loggers in business despite the decline of paper mills.

Biomass is also an important resource for forest management. We work closely with the U.S. Forest Service to develop and support wood markets to make use of low value wood materials. With millions of dead and dying trees in the West—more than 100 million in the state of California alone—biomass is sorely needed to take on the materials the federal and state governments clear from the land for forest fire prevention.

In the absence of a national energy policy, tax incentives can be an important tool to ensure that the right mix of energy sources is deployed and supported across the country. The tax system can help promote energy diversity, reduce carbon emissions, eliminate wastes, and, in the case of biomass, they promote healthy forests. Biomass is one of the few renewable energy sources whose fuel must be purchased. Many of its benefits would not be realized without the same federal incentives that

are available to other energy technologies. Further, many of our members have been unable to take advantage of Section 45 tax credits given the time it takes to build a biomass facility can be years longer than the typical one-to-two year extension of the credit. For these reasons, we believe that renewable energy tax incentives should continue to play a key role in promoting a diversified mix of renewable energy resources.

Incentives for renewable energy sources have been skewed toward wind and solar over the past decade. Low market prices for natural gas and wind, and a history of federal and state support that has tilted away from biomass have resulted in a challenging market for our members. In many areas, biomass facilities are struggling to compete or are even facing closures.

Biomass can help meet the challenges facing the grid with retiring conventional generation as well as increasing amounts of intermittent generation. Our sector is undeniably carbon friendly; we issued a study in May 2017 demonstrating that emissions from a biomass power facility are 115% lower than those of a similar-sized natural gas facility.

We would very much welcome the opportunity to work with the Senate Finance Committee to develop tax policies that will spur growth so that the biomass industry's environmental and economic benefits are fully realized. We would be honored to work with your staff to develop policies that will support a long-term, sustainable domestic biomass power sector.

Sincerely,

Carrie Annand
Executive Director

BIOMASS POWER ASSOCIATION
AMERICAN BIOGAS COUNCIL
ENERGY RECOVERY COUNCIL
NATIONAL HYDROPOWER ASSOCIATION

July 17, 2017

Senate Committee on Finance
Dirksen Senate Office Building
Washington, DC 20510–6200

Re: July 18, 2017 Senate Finance Committee hearing on "Comprehensive Tax Reform: Prospects and Challenges"

Chairman Hatch, Ranking Member Wyden, and members of the committee:

The associations representing baseload renewable industries [1] provide the following joint statement for the record on how federal tax policy impacts the growth opportunities and project deployment in our sectors.

All of our industries are struggling in the marketplace for new electricity generation as a result of being placed at a significant competitive economic disadvantage vis-à-vis wind and solar electricity by the long-term tax credit extensions provided to those technologies in 2015, while incentives for our industries were allowed to expire at the end of 2016.

As the Congress works to modernize and reform the tax code, we ask that you provide parity among renewable electricity technologies by giving baseload electricity generation technologies long-term extensions equivalent to those provided to the solar industry. The uncertainty that exists today is depressing investment in our industries and is negatively impacting our members' ability to adequately plan and implement their development objectives.

The production and use of firm, reliable baseload power from renewable energy is consistent with sound energy and environmental policy. Power from hydropower; biomass; biogas and waste-to-energy facilities is critical to the stability of the na-

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tion's electric grid, creates high-paying jobs, and helps the country meet its environmental and energy policy objectives.

Hydropower. Hydropower is the nation's single largest producer of renewable electricity and pumped storage' projects provide 97 percent of America's energy storage capacity. As reported in the 2016 Department of Energy Hydropower Vision Report. 50 GW of growth is possible across the sector. Project opportunities include: adding generation to non-powered dams; capacity additions and efficiency improvements at existing hydropower facilities; new pumped storage; conduit projects; as well as yet untapped marine energy and hydrokinetic projects.

In addition to the renewable generation hydropower itself provides to our grid, it plays an indispensable role in grid reliability and in the integration of intermittent generation. Hydro provides many ancillary grid services, such as peaking generation, load-following, voltage and frequency control, and more. Along with these critical services, hydropower projects provide many other societal benefits such as flood control, drought mitigation, water supply, irrigation, navigation, and recreation.

Biomass. Biomass power offers significant environmental and consumer benefits, including improving forest health, protecting air quality, and offering the most dependable renewable energy source. Biomass power facilities in the United States purchase as fuel organic "leftovers" like forestry residues; orchard and other agricultural prunings; hulls from rice, nut and oat production; construction and demolition waste; and unusable wood from sawmills. The fuels used by our domestic industry usually have no higher value and come from within a 50–75 mile radius of a biomass power facility, rather than being imported from elsewhere. The biomass power industry removes over 68.8 million tons of forest debris annually, improving forest health and dramatically reducing the risk of forest fires. In addition, the biomass industry diverts millions of tons of waste material from landfills and open burns.

The existence of a biomass facility in an area also greatly enhances its local forest products market. In the areas where a biomass facility is located alongside other wood products manufacturers, loggers have an additional outlet for materials they harvest. Biomass fuel can account for up to 30% of a logger's revenue—a significant amount that has helped keep some loggers in business despite the decline of paper mills.

Waste-to-Energy. There are 76 waste-to-energy (WTE) facilities located in 21 states, with a total economic impact of $5.6 billion and 14,000 direct jobs. These facilities have a nameplate electric capacity of 2,554 megawatts and generate more than 14.3 billion kilowatt hours of locally generated renewable energy annually. Working in public private partnerships with local government to provide management of their waste, this infrastructure significantly reduces the release of greenhouse gas emissions to the atmosphere, helping local governments and industries meet their individual sustainability goals.

Despite a levelized cost of electricity that is on par with wind and solar, WTE deployment has been nominal while wind and solar have seen robust growth. This is due in large part to the fact that wind and solar projects have been able to access and readily utilize federal renewable energy tax incentives and WTE technology, because of longer construction times, has not. Tax reform should address this disparity and provide WTE technology with the same treatment that is afforded solar technology under current law.

Biagas. The U.S. currently has over 2,200 operational biogas systems in the United States. A recent study released by USDA, EPA and DOE found an additional 13,500 new sites that are ripe for development. If fully realized, these new biogas systems could supply 7.5 million homes with renewable baseload power and drive $40 billion in capital development in construction activity which would result in approximately 335,000 short term construction jobs and 23,000 permanent jobs to operate the digesters. In economic comparison to variable renewable technologies, it takes six times as much solar capacity to achieve the same amount of energy produced from anaerobic digestion. Were biogas to receive the same tax advantages as wind or solar by receiving a long term stable tax credit, these systems could be deployed throughout the country to provide cost effective baseload renewable energy.

To reap the significant energy security, environmental and economic benefits associated with the production and use of baseload renewable energy, we respectfully urge you to put an end to the "winners and losers" dynamic in energy tax policy and enact even-handed, durable extensions of tax incentives for our industries.

Thank you in advance for your consideration. We look forward to working constructively with you to achieve this worthwhile policy outcome, which is critical if our national goal is to support an all-of-the above energy portfolio.

Sincerely,

Robert E. Cleaves, IV
President and CEO
Biomass Power Association

Ted Michaels
President
Energy Recovery Council

Patrick Serfass
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American Biogas Council

Linda Church Ciocci
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CENTER FOR FISCAL EQUITY

By Michael G. Bindner

Chairman Hatch and Ranking Member Wyden, thank you for the opportunity to submit these comments for the record to the Committee on Finance. As usual, we will preface our comments with our comprehensive four-part approach, which will provide context for our comments.

- A Value-Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement, and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25%.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

First, allow us to address the current state of tax reform and the comments in the press release announcing this hearing and the recent remarks by the President about priming the pump. We will then identify how our four-part approach meets the goal of this hearing to create economic growth and more jobs. The latter should be familiar to those who read our comments submitted to the tax reform hearing of one year ago.

What the Center said in June of last year in response to the release of the Blueprint bears repeating. We have tried the reduce rates and broaden the base. In 1986, it actually happened, although second mortgage interest was left deductible, leading quickly to the savings and loan crisis and eventually the 2008 Great Recession, abetted by capital gains cuts which gave us the tech bubble. Efforts to call tax cuts a prelude to growth ring hollow and even those economists who backed them no longer support such theory.

In *The Economist,* President Trump and Secretary Mnuchin cast doubt on their support for the DBCFT, instead preferring to simply cut rates for pump priming. This would mainly benefit the wealthy, which is ill-advised.

Lower marginal tax rates for the wealthiest taxpayers lead them to demand lower labor costs. The benefit went to investors and CEOs because the government wasn't taxing away these labor savings. In prior times, we had labor peace, probably to the extent of causing inflation, because CEOs got nothing back for their efforts to cut costs.

The tax reforms detailed here will make the nation truly competitive internationally while creating economic growth domestically, not by making job creators richer but

families better off. The Center's reform plan will give you job creation. The current blueprint and the President's proposed tax cuts for the wealthy will not.

In September 2011, the Center submitted comments on Economic Models Available to the Joint Committee on Taxation for Analyzing Tax Reform Proposals. Our findings, which were presented to the JCT and the Congressional Budget Office (as well as the Wharton School and the Tax Policy Center), showed that when taxes are cut, especially on the wealthy, only deficit spending will lead to economic growth as we borrow the money we should have taxed. When taxes on the wealthy are increased, spending is also usually cut and growth still results. The study is available at *http://fiscalequity.blogspot.com/2011/09/economic-models-available-to-joint.html* and it is likely in use by the CBO and JTC in scoring tax and budget proposals. We know this because their forecasts and ours on the last Obama budget matched. Advocates for dynamic scoring should be careful what they wish for.

The national debt is possible because of progressive income taxation. The liability for repayment, therefore, is a function of that tax. The Gross Debt (we have to pay back trust funds too) is $19 trillion. Income Tax revenue is roughly $1.8 trillion per year. That means that for every dollar you pay in taxes, you owe $10.55 in debt. People who pay nothing owe nothing. People who pay tens of thousands of dollars a year owe hundreds of thousands. The answer is not making the poor pay more or giving them less benefits, either only slows the economy. Rich people must pay more and do it faster. My child is becoming a social worker, although she was going to be an artist. Don't look to her to pay off the debt. Trump's children and grandchildren are the ones on the hook unless their parents step up and pay more. How's that for incentive?

The proposed Destination-Based Cash Flow Tax is a compromise between those who hate the idea of a value-added tax and those who seek a better deal for workers in trade. It is not a very good idea because it does not meet World Trade Organization standards, though a VAT would. It would be simpler to adopt a VAT on the international level and it would allow an expansion of family support through an expanded child tax credit. Many in the majority party oppose a VAT for just that reason, yet call themselves pro life, which is true hypocrisy. Indeed, a VAT with enhanced family support is the best solution anyone has found to grow the economy and increase jobs.

Value-added taxes act as instant economic growth, as they are spur to domestic industry and its workers, who will have more money to spend. The Net Business Receipts Tax as we propose it includes a child tax credit to be paid with income of between $500 and $1,000 per month. Such money will undoubtedly be spent by the families who receive it on everything from food to housing to consumer electronics.

The high income and inheritance surtax will take money out of the savings sector and put it into government spending, which eventually works down to the household level. Growth comes when people have money and spend it, which causes business to invest. Any corporate investment manager will tell you that he would be fired if he proposed an expansion or investment without customers willing and able to pay. Tax rates are an afterthought.

Our current expansion and the expansion under the Clinton Administration show that higher tax rates always spur growth, while tax cuts on capital gains lead to toxic investments—almost always in housing. Business expansion and job creation will occur with economic growth, not because of investment from the outside but from the recycling of profits and debt driven by customers rather than the price of funds. We won't be fooled again by the saccharin song of the supply siders, whose tax cuts have led to debt and economic growth more attributable to the theories of Keynes than Stockman.

Simplicity and burden reduction are very well served by switching from personal income taxation of the middle class to taxation through a value-added tax. For these people, April 15th simply be the day next to Emancipation Day for the District. The child tax credit will be delivered with wages as an offset to the Net Business Receipts tax without families having to file anything, although they will receive two statements comparing the amount of credits paid to make sure there are no underpayments by employers or overpayments to families who received the full credit from two employers.

Small business owners will get the same benefits as corporations by the replacement of both pass through taxation on income taxes and the corporate income tax with the net business receipts tax. As a result, individual income tax filing will be much simpler, with only three deductions: sale of stock to a qualified ESOP, charitable

contributions and municipal bonds—although each will result in higher rates than a clean tax bill.

For the Center, the other key motivator is expanding employee-ownership. We propose to do that by including an NERT deduction, to partially reduce income to Social Security, to purchase employer voting stock, with each employee receiving the same contribution, regardless of salary or wage level. In short order, employees will have the leverage to systematically insist on better terms, including forcing CEO candidates to bid for their salaries in open auction, with employee elections to settle ties.

Employee-ownership will also lead multinational corporations to include overseas subsidiaries in their ownership structure, while assuring that overseas and domestic workers have the same standard of living. This will lead to both the right type of international economic development and eventually more multinationalism.

Simultaneously, the high income and inheritance surtax will be dedicated to funding overseas military and naval sea deployments, net interest payments (rather than rolling them over), refunding the Social Security Trust Fund and paying down the debt.

Both employee-ownership with CEO pay reduction and paying off the debt will lead to two things—less pressure to deploy U.S. forces overseas and sunset of the income tax.

Military spending both overseas and domestic will decline under this plan. The VAT will make domestic military spending less attractive and overseas spending on deployments will be fought by income taxpayers, who are currently profiteering from such expenses. Instead, defense spending can shift to space exploration, which also increases invention and economic growth while keeping the defense industrial complex healthy, although now they can pursue profitable enterprises rather than lethality.

In short, our plan promises both peace and prosperity, not for the few but for the many. Prosperity bubbles up. It has never flowed down and tax reform should reflect that.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

CHRISTIAN SCIENCE CHURCH
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On behalf of the Christian Science Church ("Church"), we thank Chairman Hatch, Ranking Member Wyden, and the esteemed members of the Senate Finance Committee for holding the hearing entitled "Comprehensive Tax Reform: Prospects and Challenges" on July 18, 2017.

We also thank so many of the Committee members for their bipartisan support of the Equitable Access to Care and Health ("EACH") Act in the previous Congress. We deeply appreciate the Committee's leadership on tax reform and religious freedom, as embodied in the EACH Act (now H.R. 1201)—bipartisan legislation that would provide immediate tax relief to individuals and families of faith, including Christian Scientists, who have been unfairly subject to significant penalties under the Affordable Care Act's ("ACA") individual mandate. The ongoing tax burden imposed on this group of Americans—simply for adhering to their religious beliefs and practices—requires Congress' urgent attention.

ACA's Religious Conscience Exemption Does Not Appropriately Address All Americans of Faith

Under the ACA, individuals must maintain minimum essential coverage or pay a tax penalty, unless an exemption applies. The statute includes a narrow religious exemption accessible to individuals who are members of recognized religious sects described in section 1402(g)(1) of the Internal Revenue Code or health care sharing ministries. The exemption provided in section 1402(g)(1) requires members of the religious sect to conscientiously oppose the benefits of any private or public insurance, including any benefits provided under the Social Security Act.

In its current form, the exemption applies only to the Amish and certain Mennonites. It does not cover Christian Scientists, who generally participate in Social Secu-

rity and in insurance programs that cover care provided by religious nonmedical providers, such as Christian Science practitioners, Christian Science nurses, and Christian Science nursing facilities. Several existing federal, state, and private employer plans provide coverage for this care, including Medicare, TRICARE, and two FEHB plans; however, no plans offered on the Exchanges provide this type of coverage.

The unintended result of the current structure of the ACA's religious conscience exemption is that some Americans of faith are required to purchase health insurance through the Exchanges that does not cover the care that is consistent with their religious practice and individual choice, while at the same time having to pay out of pocket for the health care they actually use. The only alternative is to pay significant annual tax penalties, effectively because of their religious beliefs. Many Christian Scientists have found themselves in this untenable position since 2014.

Swift Enactment of the EACH Act Necessary to Preserve Religious Freedom in Tax Policy

To end this burdensome infringement of religious freedoms in tax policy, we urge you and your colleagues to prioritize enactment of the EACH Act this year, whether as a standalone bill or as part of any tax-related legislation.

The EACH Act, which has received broad bipartisan, bicameral support in the 113th and 114th Congresses, would expand the ACA's religious conscience exemption to include Americans who rely "solely on a religious method of healing, and for whom the acceptance of medical health services would be inconsistent with the religious beliefs of the individual." The legislation would also make whole those individuals who have been wrongfully subject to penalties under the individual mandate since 2014.

EACH is Necessary, Regardless of Health Reform Result

Despite ongoing efforts to partially address the individual mandate through ACA reform legislation, we respectfully urge the Committee to consider the EACH Act without delay, comprehensively addressing the tax implications of the individual mandate for Americans of faith, including Christian Scientists. Enacting EACH into law would ensure a clear, statutory means for exemption from the law's requirements for impacted individuals and families. It would also provide appropriate retrospective relief and set an important precedent for addressing religious conscience in health and tax law going forward.

We commend the Senate Finance Committee for its continued support of the EACH Act, which garnered broad, bipartisan support from 35 cosponsors in the 114th Congress (S. 352). In light of ongoing efforts to reform the ACA and the tax code, the Church strongly urges lawmakers to take the long overdue step of enacting the EACH Act. Church members and their families urgently need a fair solution that ends the abridgement of religious freedoms and ensures full relief from the significant tax penalties they are being required to pay.

Thank you for the opportunity to submit this statement for the record. The Church stands ready to work with Congress and the Administration to achieve this outcome as soon as possible.

Tessa E.B. Frost
Director of Federal Government Affairs
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CHURCH ALLIANCE

August 1, 2017

The Honorable Orrin Hatch
Chairman
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
U.S. Senate
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219 Dirksen Senate Office Building
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Dear Chairman Hatch and Ranking Member Wyden:

The Church Alliance is pleased to submit the following statement for the record in response to the Senate Committee on Finance's July 18, 2017 hearing on "Comprehensive Tax Reform: Prospects and Challenges." As you know, churches, synagogues, and other religious organizations are at the heart of communities across our nation. Over the years, a number of important tax provisions have developed that reflect the unique characteristics of these institutions, particularly in the areas of health and retirement security. We look forward to working with you and your staff to pursue comprehensive tax reform that preserves the spirit of these provisions, and helps all Americans save and invest for their future.

About the Church Alliance and Church Benefit Plans

The Church Alliance is a coalition of chief executive officers of thirty seven (37) denominational benefit programs, covering mainline and evangelical Protestant denominations, two branches of Judaism, and Catholic schools and institutions. These benefit programs provide retirement and health benefits to more than 1 million clergy (including ministers, priests, rabbis, and other spiritual leaders), lay workers, and their family members.

By way of background, denominational benefit plans are typically maintained by a separately incorporated church benefit organization (often called a pension board or benefit board) designated as the entity that sponsors or administers and maintains the benefit programs for eligible employees within the denomination. These benefit plans are generally multiple-employer in nature and cover thousands of church and synagogue employers throughout the country, many of which are located in rural communities. These programs often also cover foreign mission organizations and their missionaries. Church benefit organizations thus typically provide retirement and welfare benefits to thousands (or, in the case of the larger denominations, tens of thousands) of clergy and lay workers at multiple locations. Having a centralized program sponsored by one organization serving multiple church employers helps ensure continuity and consistency of employee benefits for the many clergy who move from one church or church-related organization to another to fulfill the ministry of a denomination.

The participating employers covered under these church benefit plans range from synagogues and churches to church-affiliated schools, day cares, and nursing homes. Many are small, local churches with few employees. Oftentimes, the local church's pastor may be that church's only employee. If there are other employees, they are often part-time workers who assist with secretarial or bookkeeping duties or perhaps provide for building maintenance. In addition, many small local churches are staffed by bi-vocational pastors (clergy who work for a secular employer part-time or full-time and pastor a church or churches on the side). Denominational plans also provide benefits to self-employed clergy.

In addition to serving local churches and synagogues, denominational benefit plans cover other church-related organizations that historically have been viewed by denominations as an extension of the ministry and are considered to be within the bounds of the particular denomination with which they are affiliated. For example, participating employers can include church-related nursing homes, daycare centers, summer camps, preschools, colleges, universities, hospitals, and other social service organizations. All of these organizations typically are considered as fulfilling the ministry and mission of the church.

Local churches are typically run by volunteer trustees, vestries, boards of directors, boards of deacons, boards of elders, parish councils, or the like. The individuals who hold these volunteer leadership roles are focused on fulfillment of their church's ministry and have the burden of allocating both human and monetary resources to direct ministry, which leaves them with little time to focus on employee benefit compliance issues. In the case of small to medium sized churches and synagogues, these individuals may, and usually do, lack the expertise required to understand the various employee benefit legal requirements that must be met. Except in the largest churches, the typical church budget does not support the hiring of outside experts required to assist the local church with employee benefits compliance. As a result, absent the availability of the programs provided through church benefit organizations and church associations, many of these employers would be unable to provide adequate retirement or welfare benefits to their employees.

The benefits provided by church benefit organizations or church associations may be mandated by the denominational polity (the operational and governance structure of a denomination). Over the years, church denominations have organized

themselves in a variety of ways reflecting their own theological beliefs. Some denominations are organized in a "hierarchical" polity, in which a "parent" church organization sets the policy for the entire denomination. Other denominations have organized themselves in a diocesan, synodical or Presbyterian structure under which policy-making is carried out on a local or regional level, through representatives drawn from the various churches within the geographic area served by a particular level of governance. Several other denominations, composed of autonomous churches and synagogues, or conventions or associations of churches, cooperate in a "congregational" form of governance in which churches and church ministry organizations are associated by voluntary and cooperative participation.

It is these diverse sets of church polities, and the differing levels of control exercised over churches and church ministry organizations under a particular polity, that present difficulties with employee benefit requirements of the tax code, ERISA, and other laws, most of which were designed with a for-profit, corporate structure in mind. Together with the Constitutional proscription against excessive government entanglement with religion, these considerations have led to the development of a legal framework for church plans that reflects their unique characteristics.

Priorities for Tax Reform

Central to this legal framework are several longstanding provisions of the tax code that have been carefully tailored to the needs of churches and church ministry organizations. Retaining and strengthening these provisions is critical to the retirement security of modestly-paid clergy and others who have devoted their lives to ministry. In addition, a comprehensive federal framework is important to promote clarity and consistency for church plans nationwide. As you move forward with tax reform, we urge your attention to the following issues.

Clarification for § 403(b)(9) Plans

Clarification of the rules governing church retirement plans is urgently needed to reaffirm current law dating to 1980, and more than 30 years of administrative practice to ensure that all church-affiliated organizations can participate in a church § 403(b)(9) plan. Throughout their history, the advantages of church retirement plans have been open to church clergy and lay workers serving individual churches, as well those of affiliated organizations that advance the mission of the denomination, such as children's homes, daycare centers, summer camps, nursing homes, retirement centers, preschools, colleges and universities, and other religious nonprofit entities.

The broad availability of these plans is now under threat by a recent IRS and Treasury position that departs from longstanding precedent to restrict the retirement plan options available to employees of certain religiously-affiliated organizations. Under this interpretation, employees of these organizations will no longer be able to participate in § 403(b)(9) plans. This has significant drawbacks for church retirement plans, but most importantly, for the beneficiaries they serve.

The IRS and Treasury interpretation could mean that clergy and church lay workers lose access to important § 403(b)(9) features, such as access to socially screened investment options that reflect a particular denomination's faith and beliefs, as well as to annuitization choices that can be provided directly by the church benefit program. Moreover, this approach would inevitably lead to higher costs with fewer § 403(b)(9) plan participants over which to spread plan expenses.

Recognizing these implications, bipartisan, broadly supported legislation has been introduced in the House and Senate (H.R. 2341/S. 674) to clarify the appropriate and intended broad availability of § 403(b)(9) plans. We strongly urge enactment at the earliest possible opportunity, either independently or as part of tax reform. Urgent resolution of this issue is critical to the retirement security of clergy and church lay workers across the nation.

Parsonage Allowance

For nearly 100 years, exclusion from taxation of church-provided housing to clergy has reflected the long-held belief that a clergy member's home is an extension of the church. In addition, the parsonage allowance under § 107 has been important in helping modestly paid clergy and retired clergy afford housing and move, sometimes frequently, to serve the needs of the church. This is particularly true in rural areas where many congregations are small, pay is low, and clergy are very dependent upon their churches providing or paying for their housing. This important tax policy is subject to commonsense limitations on the rental value of the home subject to the allowance, and applies to just a single property.

Moreover, the parsonage allowance must be viewed m the context of § 119, which excludes secular employer-supplied housing from employees' income under certain circumstances (*e.g.,* an on-site hotel manager's housing). However, as applied to clergy, some § 119 criteria would produce unequal results between denominations that have different theological and polity based practices relating to clergy and housing. § 107 allows clergy of all faiths to share equally in this important tax policy.

Given the continuing need for the parsonage allowance, we strongly urge its preservation as part of tax reform.

Retirement Plan Streamlining/Consolidation

As described above, church retirement plans have evolved, in some cases over hundreds of years, to reflect the unique characteristics of the denominations and populations they serve. The benefits provided by church plans are often mandated by the denominational polity (the operational and governance structure of a denomination), and are tailored to meet the needs of clergy and church lay workers who are often modestly paid. Over time, laws have been developed to work with a variety of diverse denominational structures, and to allow employees of religiously-affiliated institutions to have a meaningful opportunity to save for retirement in a manner that comports with their faith.

In this context, proposals to streamline or consolidate the various retirement plan options under the tax code (401(a), 403(b), 401(k), 457(b), etc.) threaten to eliminate provisions that church plans have come to rely upon in providing a secure, stable retirement for their beneficiaries. We caution against any streamlining or consolidation proposal that would undermine these provisions, which would also create severe compliance challenges (in some cases making the plans untenable) and burdensome transition costs for church plans and church affiliated organizations. Specifically, we urge your preservation of the following provisions that are instrumental to the retirement security of often modestly paid clergy and lay workers:

- **Different nondiscrimination testing rules.** 403(b) plans maintained by churches and qualified church-controlled organizations are exempt from nondiscrimination rules, based upon Congress's recognition of the difficulty that churches run by volunteers would have in assuring compliance with complex rules without directing their scarce resources away from mission activities; in contrast, plans maintained by larger, more sophisticated non-qualified church-controlled organizations are subject to nondiscrimination testing rules. Similarly, in recognition of the difficulty that church plans have in satisfying certain nondiscrimination rules due to their unique structures, the IRS granted an extension to the effective date of certain nondiscrimination regulations as applicable to church 401(a) qualified plans. These policies reflect the unique workforce characteristics of churches and church-related organizations.
- **Exemptions for church 401(a) plans.** With respect to defined benefit plans, the tax code reflects a number of accommodations to the unique structure of religious denominations and the plans they have designed to assure retirement security of clergy and church workers serving as called throughout their career by their denominations. These tax code provisions allow missionaries, self-employed clergy and chaplains to participate and exempt church plans from various of the qualification requirements applicable to private plans.[1] These exemptions are important because many of the rules that would conflict with the design of plans established to meet the needs of these workers decades ago or otherwise would be unworkable in the decentralized, polity-driven context of a denominational church plan.
- **Flexible investment options for church plans.** Church plans offer broad latitude for denominational benefit organizations (or their investment commit-

[1] Church 401(a) plans are not subject to numerous plan qualification requirements including, qualified joint and survivor annuities under §§ 401(a)(11) and 417; preservation of accrued benefits during a plan merger or transfer of plan assets under §§ 401(a)(12) and 414(l); anti-alienation rules of § 401(a)(13); benefit commencement requirements of § 401(a)(14); the prohibition on reducing retiree vested benefits due to Social Security increases under Code § 401(a)(15); and the prohibition on forfeiture of accrued benefits from employer contributions due to withdrawal of employee contributions under Code § 401(a)(19), if the employee is 50% vested. Church plans are subject to the pre-ERISA minimum participation standards, minimum vesting standards and minimum funding standards and exempt from the anti-cutback requirements of § 411(d)(6). Church plans also have relaxed standards for defining a highly compensated employee under Code § 414(q)(9) and domestic relations orders under Code § 414(p). There are also specialized or relaxed rules pertaining to churches in computing the limits on employee contributions under Code §§ 401(a)(17), 402(g)(7) and 415(c)(7).

tees, which are typically composed of individuals with substantial investment expertise) to offer an array of investment alternatives beyond annuity contracts and mutual funds, such as pooled investments in stocks, bonds, collective investment funds and other prudent options that benefit from lower fees and economies of scale. Many church plans also further the missions of their respective denominations by incorporating faith-based screens and positive social purposes in their investment decisions.

- **Self-annuitization feature for church 403(b)(9) plans.** IRS regulations permit sponsors of church defined contribution 403(b)(9) plans to "self-annuitize" benefits, providing valuable flexibility and stability through lifetime retirement income, at a lower cost to participants than purchasing annuities from a commercial issuer. Churches practice their commitment to care for those that serve the church by using these provisions to support these faithful servants and their surviving spouses.
- **Special annual addition limits for church 403(b) plans.** Some church employees and missionaries may have little or no taxable income due to very low compensation. Consequently, church 403(b) plans provide a special annual addition limit of $10,000 per year (subject to a lifetime maximum of $40,000), regardless of the beneficiary's taxable income. This provides clergy, lay workers, and missionaries with an opportunity to create retirement benefits while performing vital church mission work, notwithstanding their low taxable income.
- **Definition of compensation.** The limits on contributions under the different types of plans are based in part on a participant's compensation. For this purpose, compensation is defined slightly differently with respect to 403(b) plans. The differences are attributable to special rules that should be retained, such as the ability to treat former employees as having compensation for 5 years (§ 403(b)(3)), and the treatment of clergy (§ 414(e)(5)(B)). From a policy perspective, there is no reason to harm either clergy or former church employees who may need additional retirement savings.
- **Direct contributions by self-employed clergy.** Certain chaplains and self-employed clergy are authorized to make direct contributions to a church plan. Contributions to a § 403(b)(9) plan are deductible by clergy under § 404(a)(10). This is a valuable retirement savings option for clergy who might otherwise lack the opportunity to participate in a church plan.

Qualified Retirement Plan Parity With IRAs

Church retirement plans are disadvantaged relative to Individual Retirement Accounts ("IRAs") in several important respects. First, participants are eligible to make a tax-free Qualified Charitable Distribution ("QCD") directly from an IRA to a charity, but are not permitted to do so from a church retirement plan. Church plans should be allowed to facilitate tax-free QCDs for their members and beneficiaries, making it easier for clergy and other church workers to engage in charitable giving.

In addition, IRAs and church retirement plans are treated dissimilarly regarding required minimum distributions ("RMDs"). The rules applicable to IRAs are more equitable, basing the RMD amount on the age of the recipient. Church retirement plans should be able to offer the same equitable treatment for a clergy member's surviving spouse.

Corporate Integration

The Church Alliance understands and appreciates the goal of greater parity between the corporate and passthrough tax systems. However, the way in which Congress pursues this goal could have significant implications for churches and other tax-exempt charitable organizations. Specifically, we urge you to avoid any approach to corporate integration that would result in the imposition of new taxes on the earnings that these organizations receive from their investment portfolios. Increased taxation could limit returns to church benefit plan participants, eroding the stability of their retirement. We encourage you to be cognizant of the interaction with the tax exemption for non-profit organizations as you consider corporate integration proposals.

Roth Treatment

Finally, we have taken note of recent discussions about potential limitations on the amount of pre-tax elective deferral contributions to certain retirement plans; contributions in excess of these limits would be treated as post-tax or "Roth" contributions. We have serious concerns that, in addition to not yielding any "real" ad-

ditional revenue for the government (as it would merely shift the timing of collection, not the incidence of taxation), these proposals could significantly reduce the incentives to save for retirement. This could have severe consequences, particularly for modestly paid individuals who might not otherwise save for retirement absent the tax incentive provided by deferral.

Like you, we strongly believe that tax reform should make it easier and more compelling for Americans to save and invest for their future—not the other way around. We encourage you to pursue policy solutions that achieve this goal, rather than ones that could frustrate it.

In closing, the Church Alliance greatly appreciates the opportunity to submit these comments. We are pleased to serve as a resource to the Congress and the Committee on these and related matters. We look forward to our continued work together on these important issues as comprehensive tax reform moves forward. Thank you for your consideration.

Sincerely,
Barbara A. Boigegrain
Chair of the Church Alliance

COALITION TO PRESERVE CASH ACCOUNTING

August 1, 2017

The Honorable Orrin Hatch
Chairman
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of the Coalition to Preserve Cash Accounting ("the Coalition"), we are writing to explain why it is important to continue to allow farmers, ranchers, and service provider pass through businesses to continue to use the cash method of accounting as part of any tax reform plan. We appreciate the opportunity to provide these comments in connection with the Senate Committee on Finance's July 18, 2017 hearing on "Comprehensive Tax Reform: Prospects and Challenges." The Coalition applauds your efforts to improve the nation's tax code to make it simpler, fairer and more efficient in order to strengthen the U.S. economy, make American businesses more competitive, and create jobs.

The Coalition is comprised of dozens of individual businesses and trade associations representing thousands of farmers, ranchers, and service provider pass-through entities across the United States that vary in line of business, size, and description, but have in common that our members rely on the use of cash accounting to simply and accurately report income and expenses for tax purposes. Pass-through entities account for more than 90 percent of all business entities in the United States. A substantial number of these businesses are service providers, farmers, and ranchers that currently qualify to use cash accounting. They include a variety of businesses throughout America—farms, trucking, construction, engineers, architects, accountants, lawyers, dentists, doctors, and other essential service providers—on which communities rely for jobs, health, infrastructure, and improved quality of life. These are not just a few big businesses and a few well-to-do owners. According to IRS data, there are over 2.5 million partnerships using the cash method of accounting, in addition to hundreds of thousands of Subchapter S corporations eligible to use the cash method.

About the Cash Method of Accounting

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; expenses are deductible even if they have not yet been paid.

The tax code permits farmers, ranchers, and service pass-through entities (with individual owners paying tax at the individual level) of all sizes—including partner-

ships, Subchapter S corporations, and personal service corporations—to use the cash method of accounting. Cash accounting is the foundation upon which we have built our businesses, allowing us to simply and accurately report our income and expenses, and to manage our cash flows, for decades. It is a simple and basic method of accounting—we pay taxes on the cash coming in the door, and we deduct expenses when the cash goes out the door. No gimmicks, no spin, no game playing. Cash accounting is the very essence of the fairness and simplicity that is on everyone's wish list for tax reform.

Some recent tax reform proposals would require many of our businesses to switch to the accrual method of accounting, not for any policy reason or to combat abuse, but rather for the sole purpose of raising revenues for tax reform. Forcing such a switch would be an effective tax increase on the thousands upon thousands of individual owners who generate local jobs and are integral to the vitality of local economies throughout our nation. It would also increase our recordkeeping and compliance costs due to the greater complexity of the accrual method. Because many of our businesses would have to borrow money to bridge the cash flow gap created by having to pay taxes on money we have not yet collected, we may incur an additional cost with interest expense, a cost that would be exacerbated if interest expense is no longer deductible, as proposed under the House Republicans' Better Way blueprint ("the blueprint"). Some businesses may not be able to borrow the necessary funds to bridge the gap, requiring them to terminate operations with a concomitant loss of jobs and a harmful ripple effect on the surrounding economy.

Tax Reform Proposals and Cash Accounting

The blueprint moves toward a cash flow, destination-based consumption tax. The cash flow nature of the proposal suggests that the cash method of accounting would be integral and entirely consistent with the blueprint since it taxes "cash-in" and allows deductions for "cash out," including full expensing of capital expenditures. While we understand that they are different proposals, the "ABC Act" (H.R. 4377), a cash flow plan introduced by Rep. Devin Nunes (R–CA) in the 114th Congress, required all businesses to use the cash method. However, the blueprint does not provide details regarding the use of the cash method, including whether all businesses would be required to use it, whether businesses currently allowed to use the cash method would continue to be allowed to do so, whether a hybrid method of cash and accrual accounting would apply, or some other standard would be imposed.

President Trump's tax reform plan is not a cash flow plan and takes a more traditional income tax-based approach, yet the principles articulated in the administration's plan are entirely consistent with the continued availability of the cash method of accounting. Growing the economy, simplification, and tax relief are exemplified by the cash method of accounting. Requiring businesses that have operated using the cash method since their inception to suddenly pay tax on money they have not yet collected, and may never collect, is an effective tax increase, and will have a contraction effect on the economy as funds are diverted from investment in the business to pay taxes on money they have not received or as businesses close because of insufficient cash flow and inability to borrow. It is important to note that cash accounting is not a "tax break for special interests;" it is a simple, well-established and long-authorized way of reporting income and expenses used by hundreds of thousands of family-owned farms, ranches, businesses, and Main Street service providers that are the backbone of any community.

Several recent tax reform proposals, including Senator John Thune's (R–SD) S. 1144, the "Investment in New Ventures and Economic Success Today Act of 2017," would expand the use of cash accounting to allow all businesses under a certain income threshold, including those businesses with inventories, to use cash accounting. Such proposals aim to simplify and reduce recordkeeping burdens and costs for small businesses, while still accurately reporting income and expenses. A few of these proposals (not S. 1144) would pay for this expansion 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 the goals of tax reform to pay for good policy with bad policy that has no other justification than raising revenues. When cash accounting makes sense for a particular type of business, the size of the business should make no difference. Further, there have been no allegations that the businesses currently using cash accounting are abusing the method, inaccurately reporting income and expenses, or otherwise taking positions inconsistent with good tax policy.

Tax reform discussions seem to be trending toward faster cost recovery than under current law. For example, the blueprint allows for full expensing of capital

investment, Senator Thune's bill makes bonus depreciation permanent, and comments from administration officials suggest that President Trump and his team prefer faster write-offs of capital assets. Such policies benefit capital intensive businesses. However, service businesses by their very nature are not capital intensive, so it would be unfair to allow faster cost recovery for some businesses while imposing an effective tax increase and substantial new administrative burdens on pass-through service providers who will not benefit from more generous expensing or depreciation rules by taking away the use of cash accounting.

Other Implications of Limiting Cash Accounting

In addition to the policy implications, there are many practical reasons why the cash method of accounting is the best method to accurately report income and expenses for farmers, ranchers, and pass-through service providers:

The accrual method would severely impair cash flow. Businesses could be forced into debt to finance their taxes, including accelerated estimated tax payments, on money we may never receive. Many cash businesses operate on small profit margins, so accelerating the recognition of income could be the difference between being liquid and illiquid, and succeeding or failing (with the resulting loss of jobs).

Loss of cash accounting will make it harder for farmers to stay in business. 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 predictability, flexibility and simplicity of cash accounting to match income with expenses in order to handle their tax burden that otherwise could fluctuate greatly from one year to the next. Cash accounting requires no amended returns to even out the fluctuations in annual revenues that are inherent in farming and ranching.

Immutable factors outside the control of businesses make it difficult to determine income. Many cash businesses have contracts with the government, which is known for long delays in making payments that already stretch their working capital. Billings to insurance companies and government agencies for medical services may be subject to being disputed, discounted, or denied. Service recipients, many of whom are private individuals, may decide to pay only in part or not at all, or force the provider into protracted collection. Structured settlements and alternative fee arrangements can result in substantial delays in collections, sometimes over several years; therefore, taxes owed in the year a matter is resolved could potentially exceed the cash actually collected.

Recordkeeping burdens, including cost, staff time, and complexity, would escalate under accrual accounting. 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, as well as the amounts involved. In order to comply with the more complex rules, businesses currently handling their own books and records may feel they have no other choice than to hire outside help or incur the additional cost of buying sophisticated software.

Accrual accounting could have a social cost. Farmers, ranchers, and service providers routinely donate their products and services to underserved and underprivileged individuals and families. An effective tax increase and increased administrative costs resulting from the use of accrual accounting could impede the ability of these businesses to provide such benefits to those in need in their local communities.

Conclusions

The ability of a business to use cash accounting should not be precluded based on the size of the business or the amount of its gross receipts. Whether large or small, a business can have small profit margins, rely on slow-paying 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 the already agreed upon principles of tax reform, which focus on strengthening our economy, fostering job growth, enhancing U.S. competitiveness, and promoting 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 the goal of moving 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 further disadvantage them in comparison to foreign competitors. It is simply unfair to ask the individual owners of pass-through businesses to shoulder the financial burden for tax reform by forcing them to pay taxes on income they have not yet collected where such changes are likely to leave them in a substantially worse position than when they started.

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

Thank you for your consideration of this important matter.

Sincerely,[1]

Americans for Tax Reform
American Council of Engineering Companies
American Farm Bureau Federation
American Institute of Certified Public Accountants
American Medical Association
The American Institute of Architects
The National Creditors Bar Association
Akin Gump Strauss Hauer and Feld LLP
Baker Donelson
Debevoise and Plimpton LLP
Dorsey and Whitney LLP
Foley and Lardner LLP
Jackson Walker LLP
K&L Gates LLP
Kilpatrick Townsend and Stockton LLP
Lewis Roca Rothgerber Christie LLP
Littler Mendelson P.C.
Miles and Stockbridge P.C.
Mitchell Silberberg and Knupp LLP
Morrison and Foerster LLP
Nelson Mullins Riley and Scarborough LLP
Ogletree, Deakins, Nash, Smoak, and Stewart, P.C.
Perkins Coie LLP
Quarles and Brady LLP
Rubin and Rudman LLP
Squire Patton Boggs (US) LLP
Steptoe and Johnson LLP
White and Case LLP

EDUCATION FINANCE COUNCIL
440 First Street, NW, Suite 560
Washington, DC 20001
(202) 955–5510
http://www.efc.org/?
@efctweets

Education Finance Council (EFC) is the national trade association representing nonprofit and state based higher education finance organizations. These organizations are public-purpose entities that operate with the mission of increasing postsecondary access, affordability, and success. Collectively, they serve as critical resources for students and families in their states, assisting families with every facet of the higher education financing experience. Many of these organizations use the proceeds of Qualified Student Loan Bonds to fund supplemental education loans as well as education refinancing loans.

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[1] Although not a signatory to this letter, the American Bar Association (ABA) is working closely with the Coalition and has expressed similar concerns regarding proposals to limit the ability of personal service businesses to use cash accounting. The ABA's most recent letters to the House Ways and Means and Senate Finance Committees are available on the ABA's website.

EFC shares the Committee's vision for a simpler and fairer tax system, and we appreciate the opportunity to provide the following important recommendations:

Preserve Tax-Exempt Qualified Student Loan Bonds [1]

As Congress works to reform the tax code, it is imperative that policymakers preserve tax-exempt Qualified Student Loan Bonds to maintain the ability of nonprofit and state-based organizations to offer low-cost financing options that afford middle-income families the ability to pay for their college dreams.

As college costs continue to rise, many middle-income families require low-cost financing options in addition to the Federal Direct Student Loan Program. Nonprofit and state-based student loan funding providers have the unique ability to utilize tax-exempt bond financing—in the form of Qualified Student Loan Bonds—to help families fill the gap with low-cost, consumer-friendly loans. Policymakers should keep in mind, as they work to reform the tax code that repealing the tax exemption would dramatically increase the cost of these loans, adversely affecting middle-income families, who already bear a significant portion of the $1.4 trillion student debt burden.

There are currently 21 state-based and nonprofit lenders who offer education loans with low interest rates, low or no origination fees, and lower monthly payments than many other education loan options, including the Federal Direct PLUS program. For example, families who work with one state-based program can save an average of $2,500 over 10 years on a $10,000 loan, compared to if they had taken out a PLUS loan.

Most of these organizations also provide the in-depth counseling that borrowers need to understand and manage their loan responsibilities and guide borrowers through all repayment options available to them—with special attention paid to working with borrowers who experience economic hardship. In the past year, EFC Members directly worked with over 2.5 million families to help them successfully plan, save, and pay for college. And, during their 2016–2017 fiscal year, nonprofit and state-based organizations made more than 84,000 loans to more than 75,000 borrowers, totaling $1.2 billion. Collectively, their outstanding portfolios include 1.1 million in loans totaling $9.2 billion, representing more than 490,000 borrowers.

Additionally, 13 nonprofit and state-based organizations offer refinancing loans, making education debt more manageable for families by providing a refinancing tool that consolidates high-interest rate education loans into a single loan, reducing overall debt burden and, in many cases, reducing monthly payments by as much as $200 or $300 per month—saving borrowers anywhere from $3,000 to $5,000 over a 10-year repayment term.

Tax-exempt Qualified Student Loan Bonds also allow nonprofit and state-based student loan organizations to serve as critical resources for the citizens of their states, assisting families with every facet of the higher education financing experience. These organizations use any excess revenues to help fund extensive free programs to counsel students to choose the best-fit school, borrow appropriately, complete their degree, maximize their earning potential, and successfully repay their loans.

In the past year, these organizations worked directly with 2.5 million students and families, and:

- Granted over **$655 million** in scholarships.
- Hosted programs at over **14,000** schools, community centers, libraries, and other sites.
- Assisted **1 million** students with their college applications.
- Awarded **$577 million** in grant funds.
- Assisted in the filing of more than **76,000 FAFSAs**.
- Hosted over **16,000** community presentations for students and parents surrounding college planning and financial aid.

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[1] Qualified Student Loan Bonds fall under the municipal bond tax exemption. Initially, student loan bonds were treated as governmental bonds, and were not what the 1954 Internal Revenue Code described as industrial development bonds (and that are now known as "Private Activity Bonds," which are subject to many more restrictions than governmental bonds). In 1984, Congress changed the tax-exempt bond rules to make interest on what were described as "Private Loan Bonds" taxable. But "Qualified Student Loan Bonds," under then-applicable Section 103(o), were not treated as "Private Loan Bonds" for this purpose.

When the 1986 Tax Act put the Internal Revenue Code of 1986 in place, the concept of a qualified student loan was incorporated into Section 144(b) of the Code. Qualified Student Loan Bonds are now Private Activity Bonds and are subject to volume cap limitations.

- Presented programs on financial literacy, budgeting, and college planning to over **520,000** high school students and their families.
- Presented programs on financial literacy, budgeting, and college planning to over **50,000** elementary and middle school students and their families.
- Provided financial literacy training and programs to over **57,000** students and families.
- Distributed over **4.5 million** brochures, fact sheets, guides, newsletters, and webinars.
- Held over **2,300** counselor- and teacher-training workshops.

In order to retain the ability of nonprofit and state-based organizations to provide low-cost, consumer-friendly loans to middle-income families, and their ability to offer extensive free outreach programs, it is critical to preserve tax-exempt Qualified Student Loan Bonds.

Eliminate the Alternative Minimum Tax

EFC supports the proposed elimination of the Alternative Minimum Tax (AMT), which would minimize costs to education loan borrowers. Congress' previous temporary elimination of the AMT on income earned from Private Activity Bonds resulted in lower borrowing rates for student loan issuers, with those savings passed directly to student loan borrowers.

For example, a student borrowing $20,000 could save $500 or more in lower interest payments on a 10-year loan with the elimination of the AMT. Nonprofit and state-based education finance organization are committed to once again passing any savings from the elimination of the AMT directly to borrowers in the form of lower interest rates.

Update "Qualified Scholarship Funding Corporation" Rules

As noted above, nonprofit and state-based education loan financing providers, through the issuance of Qualified Student Loan Bonds, are uniquely situated to make supplemental education loans with the best possible terms and to make education refinancing loans at low interest rates. However, certain nonprofit and state student loan funding providers—"qualified scholarship funding corporations" under Section 150(d) of the Internal Revenue Code—are currently ineligible to issue Qualified Student Loan Bonds to finance supplemental education loans and refinance education loans.

Section 150(d) allows only qualified scholarship funding corporations to issue Qualified Student Loan Bonds to acquire education loans incurred under the HEA, which was the Federal Family Education Loan Program (FFELP). An update is needed to the Internal Revenue Code to allow qualified scholarship funding corporations to utilize Qualified Student Loan Bonds to fund supplemental education loans and refinancing loans.

EFC endorses H.R. 480, the Student Loan Opportunity Act, introduced by Rep. Bill Flores (R–TX), which would allow qualified scholarship funding corporations to issue Qualified Student Loan Bonds to fund supplemental education loans for students attending school and provide low-cost refinancing loans to borrowers once they leave school. We recommend that H.R. 480 be included in tax reform efforts currently underway so as to extend the same opportunities to residents of all states. This would ensure that students and borrowers have the broadest access possible to low cost supplemental education and refinancing loans.

Stop Taxing Death and Disability

EFC strongly supports efforts to exempt from federal income tax private and federal education loans that are discharged due to the death or total and permanent disability of a student, and to allow the parent of a student that becomes totally and permanently disabled to have their federal loan discharged.

Adding federal and private student loan discharges as a result of death or total and permanent disability to the existing list of tax-exempt discharges is a commonsense and compassionate reform, modeled on current exemptions that public sector employees and borrowers with a closed school discharge already receive.

EFC endorses the bicameral, bipartisan Stop Taxing Death and Disability Act and recommends it be included in the current tax reform effort.

LETTER SUBMITTED BY MARTHA HENDERSON

U.S. Senate
Committee on Finance
Tuesday, July 18, 2017

Re: "Comprehensive Tax Reform: Prospects and Challenges"

Members,

It is a relief to know that after many years of discussion from across the ideological spectrum about the inadequacy of our tax system the Senate Finance Committee is making tax reform its top priority. As Senator Orrin Hatch stated in his speech on the Senate floor on July 12, 2017, ". . . we need to go back to the drawing board and fundamentally rethink our entire tax system. This includes both the individual, as well as business side of the tax ledger." Tax reform needs to benefit the U.S. economy by providing its citizens with fairness and better opportunities in the global marketplace.

My comments focus on the need to fix the administrative and financial burdens imposed by the current tax system on individuals living and working abroad. The current system is complex and unfair. Tax compliance for us is exceedingly time consuming and expensive—particularly in terms of savings and investment for retirement purposes but also with regard to annual tax preparation.

I have lived and worked in Australia since late 1973. I am one of an estimated 13% of American expats living abroad who submit annual U.S. tax returns.[1] I am also tax-compliant in Australia. The current U.S. tax system has financially disadvantaged me with respect to taxation of my Australian retirement savings, taxation of foreign mutual funds and currency fluctuations as they affect capital losses for U.S. tax purposes.

In my view, a well-designed residency-based tax system that includes anti-abuse provisions and continues to tax individuals for U.S.-sourced income would provide very positive outcomes for the U.S. economy and effectively address all of the disadvantages I have experienced. It would:

- Provide incentive to U.S. companies doing business abroad to employ American citizens for their overseas operations.
- Provide employment opportunities and mobility for individuals functioning in the global economic environment.
- Provide fairness to non-resident citizens by eliminating double taxation.
- Reduce the impact of currency fluctuations for non-resident citizens.
- Reduce the complexity and financial and time burdens associated with compliance.

A workable system would provide for the following:

- "Non-resident Americans"—would be treated the same as non-resident alien individuals not living in the United States. The definitions of U.S. citizen and resident alien would be the same as those that exist under current law.
- Non-resident Americans would continue to be taxed on business income and capital gain from the sale of real estate in the United States.
- Individuals could opt in or out of a residency-based system. They would have to meet specific requirements to qualify for residency based taxation
- "Savings clauses" in tax treaties, which preserve the U.S.'s ability to tax its citizens, would be overridden in the statute, thus relieving individuals of the burden of double taxation on retirement savings.
- FATCA legislation would be amended to add a "same country" exemption for certain accounts of individuals residing in a foreign jurisdiction, where the account is with a foreign financial institution in the same country where the individual resides. Amendment would also alleviate the need for submission of Form 8938 if the only foreign financial assets that would have been reported on such form had been properly reported on a foreign income tax return.

Sincerely,

Martha Henderson

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[1] Burggraf, Helen (2015, April 1), "On the Trail of the Illusive U.S. Expat Taxpayer." *Wall Street Journal.* Retrieved from *http://blogs.wsj.com/expat/2015/04/01/on-the-trail-of-the-elusive-u-s-expat-taxpayer/*.

LIKE-KIND EXCHANGE STAKEHOLDER COALITION

August 1, 2017

The Honorable Orrin Hatch
Chairman
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

Dear Chairman Hatch and Ranking Member Wyden:

We are submitting the following statement for the record in response to the Senate Committee on Finance's hearing on July 18, 2017 entitled "Comprehensive Tax Reform: Prospects and Challenges." As you consider ways to create jobs, grow the economy, and raise wages through tax reform, we strongly urge that current law be retained regarding like-kind exchanges under section 1031 of the Internal Revenue Code ("Code"). We further encourage retention of the current unlimited amount of gain deferral.

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 taxpayers 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 back into the enterprise, which is the very reason section 1031 was enacted in the first place. This continuity of investment not only benefits 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 like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity.

A 2015 macroeconomic analysis by Ernst and Young found that either repeal or limitation of like-kind exchanges could lead to a decline in U.S. GDP of up to $13.1 billion annually.[1] The Ernst and Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, manufacturers, etc. A 2016 report by the Tax Foundation estimated even greater economic contraction—a loss of 0.10% of GDP, equivalent to $18 billion annually.[2]

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 real estate, construction, agricultural, transportation, farm/heavy equipment/vehicle rental, leasing and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

A microeconomic study by researchers at the University of Florida and Syracuse University, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.[3] The immediate recognition of a

[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/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.*

[2] "Options for Reforming America's Tax Code," Tax Foundation (June 2016) at p. 79, available at *http://taxfoundation.org/article/options-reforming-americas-tax-code.*

[3] David 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

gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A $1 million limitation of gain deferral per year, as proposed by the Obama Administration,[4] would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle/equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes, multifamily properties or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property/casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and provides inventories of affordable used assets for small businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity.

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,

Air Conditioning Contractors of America
American Car Rental Association
American Rental Association
American Seniors Housing Association
American Truck Dealers
American Trucking Associations
Associated Equipment Distributors
Associated General Contractors of America
Avis Budget Group, Inc.
Building Owners and Managers Association (BOMA) International
C.R. England, Inc.
Equipment Leasing and Finance Association
Federation of Exchange Accommodators
International Council of Shopping Centers
Investment Program Association
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of REALTORS®
National Automobile Dealers Association
National Business Aviation Association
National Multifamily Housing Council
National Ready Mixed Concrete Association
National Stone, Sand, and Gravel Association
Truck Renting and Leasing Association

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http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.

[4] "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," at 107, available at *https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.*

NRS INC.

STATEMENT OF BILL PARKS

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

Domestic companies pay far more tax than their multinational competitors. This is because more than 80 years ago, the U.S. went down the wrong path of taxation policy and dragged the rest of the world with it. Back then, the U.S. recognized that a multinational enterprise (MNE) could price products internally to move profits to low- or no-tax countries. For this reason, the United States required companies to set the price for the transfer of products between countries at the market price that would be set between unrelated companies. But it was soon apparent that this could only work for basic commodities, since all other products could be considered to be special. Coffee beans aren't just coffee beans if they're Starbucks beans. In other words, specialty products can command a premium price.

All product transactions can also be disaggregated. For example, one MNE's product made in Germany may be purchased by a Bermuda subsidiary, insured by an Isle of Man subsidiary, financed by a Cayman Islands subsidiary, with logistics handled by still another subsidiary. Thus the product is purchased at a low price from the German subsidiary, leaving little profit in Germany. And it is sold to the U.S. subsidiary at a high price, insuring little or no profit in the United States. And that is just the simplest example of how to minimize U.S. corporate taxes. Worse, with little or no corporate profit in the United States, states are also shortchanged.

The U.S. taxes the global earnings of companies but allows a company to defer foreign earnings permanently invested outside the United States. As a result, U.S.-based MNEs receive a perpetual interest-free loan from the federal government on all their foreign earnings that have mostly been stripped out of U.S. operations and moved to the world's tax havens.

Domestic companies competing with MNEs face a daunting task. How do they compete with an MNE that pays no tax while they are paying up to 40% or more in state and federal tax? That this is accepted should be a scandal. We should be equally outraged at the corporate tax disparity between domestic and multinational companies.

Problems in Most Proposals

Most proposals so far considered provide a step forward and at least one step back as MNEs create more sophisticated ways to move profits. Consider these proposed ideas:

The Republican House made a giant step forward by advocating for a destination-based corporate tax. Unfortunately, it then proposed the border-adjusted tax (BAT). The BAT would deny a business deduction for any imported goods. At their suggested 20% tax rate, it could raise the price of imported goods by 15% or even more. Conversely, revenues from exports would not be counted. Along with the many objections voiced by retailers and other businesses, BAT creates the hidden problem associated with the U.S. annual export of $1.25 trillion in commodities. Any domestic company could buy and export a commodity such as wheat, coal or cotton, erasing its profits. Essentially BAT allows a dollar of export sales to erase a dollar of pretax income. This strategy erodes so much taxable income that it would require a much higher tax rate than the suggested 20% to be revenue neutral.

Many propose ending deferral as a solution, which is appealing but while it puts domestic and U.S.-based MNEs on a level footing, it doesn't affect foreign-based MNEs. This ultimately puts all U.S. companies at a disadvantage in both domestic and world markets.

Many suggest a simplistic change to a territorial system. Such a change would certainly solve the international competitiveness problem for U.S. MNEs. However, it would increase the disparity between domestic companies and their MNE competitors and it would require a rate increase to be revenue neutral.

Substantially lowering the 35% U.S. corporate tax rate leaves in place the disparity between domestic companies and their MNE competitors. It would also massively

decrease revenue. We should likewise reject the assumption that lower corporate tax rates will resolve the disparity.

Any corporate tax system that includes transfer pricing can never be fixed because: "By far the most persuasive objective of international transfer pricing is tax minimization."

One of the problems inherent in the tax controversy is that most economists propose to tax "where the economic activity occurs." In other words, where the factory or administration occurs because they believe that is what produces profit. But when you ask many business people they are likely to say it is the customer that creates the profits. Without a customer all those activities only produce costs. And there is a practical aspect as well. It is well known that taxing something will result in less of it. The United States certainly doesn't want to reduce the amount of domestic payroll or property because if economic activity is occurring in the United States and is taxed domestic manufacturing will be reduced. Thus it makes sense to shift from origin-based taxation to destination-based taxation. And while companies are known to shift their operations to avoid taxation, it is much harder, if not impossible to move customers.

The Better Path for Moving Forward

A destination-based corporate tax sometimes called Sales Factor Apportionment (SFA) would take the percentage of a company's total sales made in the United States and apply that percentage to the company's worldwide pretax profit to determine the amount of taxable income in the United States. This change would exempt domestic companies from paying tax on their exports but require all MNEs, both U.S. and foreign, to pay taxes on the pretax profit that is in proportion to their sales in the United States. SFA is estimated to increase revenue by at least $100 billion a year or allow a revenue neutral rate reduction from 35% to less than 26%.

To further counter tax avoidance, the permanent establishment requirement to establish a nexus for taxation should be updated for the digital age. Such an update could consider following in the steps of New York State, which deems a company to have a taxable presence if it had U.S. sales above a certain amount, for the United States. I'd suggest between $2.5 and $5 million.

An interesting side benefit of SFA is that it removes the competitive advantage of low rates. For instance, Ireland, with a population of less than 5 million, has an exceptionally low tax rate that attracts profits from around the world, but its low tax rate would not hurt other countries if these countries used SFA. For instance, Germany, France and the UK, all have more than 10 times Ireland's population and almost certainly most MNEs would have more than 10 times their Irish sales in each country. Therefore each country would receive more than 10 times the taxable revenue from an MNE. Ireland's low rate would no longer attract MNE profits because it wouldn't change what the MNE paid in other countries. Basically, MNEs could no longer siphon off profits from operations in any country to tax havens.

If the United States led in embracing SFA, its advantages would soon be so obvious that many countries would consider moving to SFA. However, no matter what other countries do, the United States has no (good) excuse not to adopt SFA. Some less developed countries should consider adopting formulary apportionment but because they do not have robust consumer markets, their emphasis might be on payroll or tangible property.

Regardless of which tax policies other countries adopt, SFA is clearly the best for the Uited States. It sidesteps the race to the bottom but could be used to lower rates while still being revenue neutral or even positive.

LETTER SUBMTTED BY JUDITH PERRY

I am writing to you regarding the tax reform legislation currently before your committee and wish to address overseas pensions and territorial taxation for individuals.

Americans working overseas pay local taxes and participate in the local pension scheme. They do this in good faith and expect the pension to be there when they retire be that overseas or back in the United States. They usually have no idea that there could be a problem with recognition of this by another jurisdiction resulting in taxation of the pension twice, once in the country where the pension originated and again by the United States. This may be their only pension, particularly if they

have spent significant portion of their career overseas and have not been able to contribute to a U.S. pension scheme.

Clearly this situation is serious impediment to these middle class Americans saving for retirement. For the individual and American companies this adds costs and uncertainty thereby impeding U.S. international economic growth, jobs for Americans overseas and attracting international talent to relocate to the United States.

In order to bring surety to Americans with an overseas pension I ask that you support updating and simplifying the approach to these pensions by taxing *all* legitimate overseas pensions only once by the country where the pension originated. Similarly, pensions originating in the United States should be taxed only once, in the United States, under the laws governing pensions here. Many countries already have this system further exacerbating our competitiveness overseas.

I also seek your support to change the current citizen-based tax to a territorial tax system for individuals. This has the benefit of simplifying the tax code, reduce regulatory costs, enable U.S. individuals and companies to be more efficient and compete on a level playing field with foreign firms in domestic and foreign markets. This may also remedy the overseas pension issue providing the pension is not double taxed along the lines discussed above.

Yours sincerely,

Judith Perry

STATEMENT SUBMITTED BY JAY STARKMAN, CPA

Today's hearing featuring former assistant secretaries for tax policy Jonathan Talisman, Pamela Olson, Eric Solomon, and Mark Mazur, showed that Congress is anxious to revise the Internal Revenue Code to make it fairer, simpler, more efficient, and foster American competitiveness. As a champion for tax simplification for my entire career and having achieved some successes, I have unique observations to share regarding the hearing which mostly concentrate on tax simplification.

Tax complexity erodes voluntary compliance and reduces revenues by making the tax laws difficult to understand and, thus, to comply with. Ultimately, taxpayers lose respect for the tax system itself. They create abusive tax shelters attempting to benefit from gray and incomprehensible tax provisions.

Simplification is the ability of taxpayers and their advisers to understand and comply with the tax laws which pertain to them, and the ability of IRS to administer such laws. Simplifying taxes requires rough justice as there will be winners and losers.

What Causes Tax Complexity?

Tax provisions may be classified as "structural" or as "tax expenditures." Structural provisions are those necessary to implement a tax on net income. Often, underlying transactions are extraordinarily complex and require a complex tax law. However, a complex tax law can still be logical and coherently structured. Here, simplification means controlling complexity. Utilizing the services of the legislative counsel's office can significantly improve tax code language resulting in more readable and understandable provisions with better certainty how courts will interpret the statute.

Tax expenditures are tax subsidies or financial incentives. They constitute the single biggest cause of complexity in our income tax system because they are not needed to implement a tax on net income. Few tax expenditures help the nation as a whole.

There is no vocal and effective constituency for tax simplification. It requires champions in Congress and the Administration. There will be faint praise for promoting tax simplification, only potential risks to legislators for promoting some unpopular changes needed to achieve simplification. Lobbyists meet any efforts at simplification through restriction of an existing tax expenditure with a well-financed campaign portraying social or economic upheaval if their client's particular tax subsidy is curtailed. Each new tax expenditure is equally hailed as the solution that the country has been waiting for.

Home mortgage interest, state tax and charitable deductions, individual retirement accounts, the standard deduction, and child credits are examples of tax expenditures with broad constituencies. Accelerated depreciation, oil and gas depletion, parsonage

exclusion, low income housing and energy credits have narrower but very powerful constituencies.

There is nothing inherently wrong with tax expenditures, provided a complete cost/benefit analysis determines that each one is the most efficient method for a necessary government intervention in the economy. No such analysis is being performed resulting in many inefficient tax expenditures.

There is a built-in bias toward tax expenditures. Non-tax writing committees can further their mission, (*e.g.,* ensuring better housing or employment) by proposing or supporting tax expenditures. The tax writing committees gain a new constituency of those affected by the program. A Senate Finance Committee member interested in climate change, for example, can gain a political foothold in this area without being a member of the Committee on Environment and Public Works.

Complexity and the Budget Process

If a government agency cannot obtain an appropriation for a comparable program in its own budget, it will almost inevitably favor a tax expenditure—any tax expenditure—as an extension of its own direct programs. Unlike spending programs, they are immune from automatic spending cuts. They can skirt the Byrd rule by front-loading expenditures while back-loading revenues, and expire in 10 years. Everyone wins by not requiring a trade-off between tax expenditures, direct expenditures and realistic budgeting—except the nation as a whole.

In the present political climate, taxes cannot be raised explicitly. This has contributed to complexity as lawmakers resort to base broadeners, stricter compliance, and user fees—which means closing loopholes, restricting tax expenditures, more information reporting, faster tax collections, and higher penalties. These are called "cats and dogs" because they raise little revenue when considered singly, but in the aggregate, all of these complex provisions raise a great deal of revenue needed to meet the budget targets. This has resulted in penalties so numerous (and some draconian) that no one can count them all, up from just six in the original Internal Revenue Code of 1954.

Cats and dogs are popular because few are affected by penalties, excise taxes, and highly targeted base broadeners. Targeted taxpayers find them frustrating and quite hard to challenge.

Finding dozens of highly targeted cats and dogs takes time. No time remains to consider simpler alternatives to the complexity of the resulting tax bill. It becomes a tax increase that is complex but politically acceptable. Because of the budget deficit, decisions are based more on the amount of revenue to be derived than on coherent tax policy. Legislators believe that fine tuning provisions for revenue requires regulation type statutory language as if each sub-subsection could be costed out.

The Code contains at least 19 tax incentives to encourage college attendance.[1] It also contains one disincentive that full-time students aged 19–23 will be taxed the same as minors under age 19—at their parents' marginal tax rate—included as a revenue offset in 2007. This is prime simplification territory.

The 1986 Tax Reform Act

The 1986 Tax Reform Act lowered rates and broadened the tax base. It's a road map on how to pass a major tax overhaul without much simplification. It introduced very complex baskets of portfolio, passive and active income, burdened foreign income reporting, and many other provisions that vastly complicated tax compliance. The biggest simplification, taxing capital gains at ordinary income rates, was soon repealed, and an exemption to passive losses for real estate professionals was added.

In the 1986 deliberations, Senate Finance Committee Chairman Bob Packwood explained the need to shield legislators from lobbyists, the press, and the public in order to make progress:

> When we're in the Sunshine, as soon as we vote, every trade association in the country gets out their mailgrams and their phone calls in 12 hours and complains about the members' votes. But when we're in the back room, the Senators can vote their conscience. They vote for what they think is good for the

[1] Eighteen are listed in Joint Committee on Taxation, "Background and Present Law Related to Tax Benefits for Education" (JCX–70–14), June 2014, available at *www.jct.gov.* There is also a gift tax exclusion for tuition paid on behalf of a student by a third party.

country. Then they can go out to the lobbyists and say: "God, I fought for you. I did everything I could. But Packwood just wouldn't give in."[2]

Tax Simplification for the Majority

Except for the recordkeeping burden, the general public is shielded from most tax complexity. When they encounter a complex tax situation, they hire an adviser. Thus, tax complexity means only "How much does it cost to prepare my return?" and "How big is my refund?"

The most recent IRS statistics reveal that in 2014, 73 percent of the returns filed with the IRS yielded just 11 percent of individual tax revenue. That's 108.3 million of the 148.6 million returns processed. That 73 percent includes all single persons grossing up to a little over $47,000 annually and all married couples earning up to a little over $94,000. It means that an inordinate amount of resources are devoted to collecting $148.4 billion of tax. The remaining 27 percent of tax filers yield $1.2 trillion, 89 percent of all income tax. IRS expends inordinate resources on lower income taxpayers because fraud within this group, abetted by tax complexity and efiling, exceeds the annual IRS budget.

Senator Hatch began the hearing by declaring, "American families, individuals, and businesses collectively spend hundreds of billions of dollars a year—not to mention countless hours—simply trying to comply with the tax code."

Senator Elizabeth Warren has introduced the "Tax Filing Simplification Act of 2017" (S. 912). It would require IRS to establish and operate the following programs free of charge:

- Online tax preparation and filing software;
- Allow taxpayers to download third-party provided return information relating to individual income tax returns; and
- Permit individuals with simple tax situations to elect to have the IRS prepare their returns.

The presence of Obamacare "excess advance premium tax credit repayment" and "individual responsibility penalty" could make S. 912 difficult to implement. Still, serious consideration should be given to Senator Warren's proposal which could dramatically simplify taxes, even eliminate tax return preparation costs. IRS already has all this information. At a minimum, it would be a great "milker" bill. Intuit spent $1.25 million on lobbyists and gave $2.12 million to 120 California politicians from 2005 to 2010 to defeat the California pilot project, ReadyReturn from launching statewide.[3]

Consumption Taxes

I was disappointed to hear Senator Johnny Isakson discuss the insidiously named, FairTax. This is a discredited 2003 proposal by Congressman John Linder (R–GA) which claims that a 30 percent national sales tax could replace income, payroll, estate and gift taxes.[4] Combined with up to 10 percent state sales tax, a 40 percent consumption tax would incentivize black markets and depress economic activity. The rate would be even higher once food, medicine, and other exclusions are applied. And there would still be state income tax, up to 12 percent. National sales tax proposals were resoundingly defeated in 1932 and 1942 to allow states exclusive dominion and because they are regressive.

Some claim we have placed ourselves at a great disadvantage by relying on income taxes without a VAT. Most countries use some form of consumption tax denominated a VAT or goods and services tax. VAT countries can be divided into three groups, based on the reason that each adopted a VAT:

- *European Union.* VAT is a requirement for membership in the EU, and it has been adopted by EU candidates.
- *Developing nations.* Countries with immature or evasion-ridden tax systems have adopted a VAT because it's relatively easy to establish and administer.

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[2] Birnbaum, Jeffrey H., and Allen S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (New York: Random House, 1987), page 260.

[3] "Intuit's end-run," *Los Angeles Times,* July 21, 2010, *http://articles.latimes.com/2010/jul/21/opinion/la-oe-ventry-intuit-20100721;* "The Stanford Professor Who Fought the Tax Lobby," *https://priceconomics.com/the-stanford-professor-who-fought-the-tax-lobby/*.

[4] FairTax supporters argue that the 30-percent tax is really 23 percent. Math as follows: a $100 item with 30% sales tax costs $130, that's 23% "tax inclusive:" $130 – ($130 x 23%) = $100. Thus $30 tax added to a $100 purchase is a 23% tax!

South Korea, for example, adopted a VAT in 1976 because its existing tax system couldn't adequately police other forms of taxation.

- *Other reasons.* Some countries use a VAT to fund social programs (Australia), to maintain fiscal stability (Canada and Japan), or to incentivize relocation of foreign export businesses (China).

All who complain that our corporate income tax rate is the highest among all OECD nations fail to acknowledge that those countries impose a VAT, or worse, suggest this as a reason we need a VAT. The U.S. overall tax burden, absent a VAT, is lower than that of other OECD nations.

Former House Ways and Means Committee Chair Wilbur Mills explained that Europe adopted VAT as a substitute trade barrier, because it was needed to compensate for the revenue loss from tariff reductions caused by liberalized trade with the United States:

> We didn't say anything, publicly, at least, about the fact that the European Common Market adopted such a system. They did it to offset the concessions, which they had given, in a trade agreement to us in the way of reduction of duties. We didn't say anything about it, even though the Value Added Tax did make it more difficult for us to export into the European Common Market.[5]

VAT rebated by other nations as a border adjustment does place the United States. at a competitive disadvantage. For political reasons, the Supreme Court did not considered this an illegal "bounty" that requires Treasury to levy a countervailing duty equal to the amount that had been rebated. A U.S. border adjustment tax might alleviate this disadvantage and there is precedent for imposing it.[6]

Stanley Surrey, Assistant Treasury Secretary in the 1960s who coined the concept "tax expenditures," opposed a VAT as "just a general retail sales tax collected in a different way." He wrote that adoption of a national sales tax would make the U.S. federal tax system "distinctly worse." Regarding international trade, he argued that a national sales tax would not bring any advantages to the United States. Finally, he argued, "if a national sales tax were ever deemed desirable in the United States, it should take the form of a retail sales tax and not a value-added tax."[7]

A 1967 Joint Economic Committee study concluded:

> The European Common Market practice of rebating their own indirect taxes on their exports and levying these same taxes on imports—a practice sanctioned, incidentally by the rules of the GATT—constitutes a conspicuous form of discrimination against U.S. exports. Moreover, similar border adjustments by the United States would be an ineffective weapon, neither mitigating nor offsetting the discriminatory process, because the tax structure of the United States places relatively small emphasis on indirect taxes.[8]

Our corporate income tax may be the highest among the OECD countries, but our zero VAT is the lowest. That's one reason foreigners flock to our shores, to purchase products exported from their own countries tariff free and VAT free, cheaper than at home. A prior generation called it "dumping."[9]

Implementing a 15-Percent Business Tax Rate

It's naive to assume that lowering tax rates will make corporations more amenable to paying income tax. The modern accounting profession got a major boost from the Revenue Act of 1909 which imposed a 1-percent tax on corporations. A frenzy of tax planning followed to avoid that minor levy. Large corporations today maintain a tax department, not as a mere administrative center, but as a profit center. It is expected to find or devise methods to minimize taxes. Senator Bill Cassidy appreciated this when he commented, "Some of these high-tech companies have very low effective tax rates. . . . How much lower can you get than zero?"

Citizens for Tax Justice regularly publicizes how more than a quarter of the Fortune 500 companies paid an effective federal income tax rate of less than 15 percent over

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[5] Wilbur D. Mills, "Tax Legislation—A Look Into the Future," 38 NYU. *Tax Inst.* 31 (1980).

[6] *Downs v. United States,* 187 U.S. 496 (1903), *G.S. Nicholas and Co. v. United States,* 249 U.S. 34, 39 (1919), *Zenith Radio Corp. v. United States,* 437 U.S. 443 (1978) deference to Treasury, 562 F.2d 1209 (C.C.P.A., 1977), rev'g 430 F. Supp. 242 (Cust. Ct., 1977).

[7] Stanley S. Surrey, "Value-Added Tax: The Case Against," 48 *Harv. Bus. Rev.* 86 (November–December 1970).

[8] "The Future of U.S. Foreign Trade Policy," 90th Cong. 1st Sess., at 5 (1967).

[9] Frank Langfitt, "Made in China Doesn't Mean Cheap in China," NPR, Morning Edition (November 23, 2011).

an 8-year period. It claims that more than 73 percent of Fortune 500 companies maintain subsidiaries in offshore tax havens. Collectively, multinationals reported keeping $2.5 trillion offshore (just 30 companies account for 66 percent of this total), awaiting the day of cheap repatriation or tax holiday. After tax breaks and deductions, Citizens for Tax Justice, noted that corporations pay an average effective rate of 18.5 percent rather than the 35 percent statutory rate. The Congressional Budget Office reported that in fiscal 2011, corporations paid income tax of just 12.1 percent on profits earned from activities within the United States.[10]

M. Carr Ferguson, former chair of the American Bar Association Section of Taxation, recommended transparency in publicizing the authorship and intent of tax provisions, elimination of loopholes, which might even justify a revenue-neutral tax rate as low as 15 to 20 percent and writing terser provisions of broader application. He suggested "corporate tax revenues might actually increase" if only we would trust the commissioner and the courts to interpret and apply the provisions sensibly.[11]

Valid concerns were expressed at the hearing over how to implement President Trump's proposal to lower the business tax rate to 15 percent without setting off an avalanche of tax avoidance. Suggestions to restrict the low rate to capital and exclude service income would be subjective and complex. A less complex and subjective method would be to tax at the individual tax rate any funds distributed from a pass-through entity. Only undistributed funds retained in the business would be taxed a 15 percent. That way, the 15 percent tax becomes a tax deferral, available as capital to expand business, without creating an unfair advantage over wage earners. It's not too different from the "previously taxed income" category for S corporations prior to the Subchapter S Reform Act of 1980. It's a complexity this author does not like, but probably the best way to avoid abuse of a preferential rate while fulfilling the goal of employing capital in a business. Consider that professional service corporations also need capital and should not be subject to a higher tax rate than other entities. Elimination of this PSC exception would be a tax law simplification.

OECD implementation of Base Erosion and Profit Shifting is a desperate effort to prevent unintended tax avoidance on intellectual property. Establishing domicile for IP in a tax haven is how high tech companies pay such very low income tax rates. Any shift by the U.S. to a territorial tax will have to consider a version of BEPS.

Funding IRS

Admitting that Congress under-funds IRS, Senator Tom Carper was impressed by Mark Mazur's comment, "Underfunding the IRS is like underfunding your accounts receivable department. No rational business would do that." So, why has Congress authorized private tax collectors to collect outstanding tax debts instead of collecting them in-house?

According to Commissioner Mark Everson (2002–2007), IRS could collect the tax for less, but increasing the IRS budget counts against the 10-year revenue projection, while hiring outside contractors does not.[12]

Attempts at private tax collection in 1872, 1996, and 2006 were dismal failures. New Jersey's attempt ended in a 2005 scandal. The City of Richmond, Virginia also failed. A congressional investigation following the 1872 fiasco concluded, "any system of farming the collection of any portion of the revenue of the Government is fundamentally wrong," and concluded that only the Bureau of Internal Revenue should collect taxes. The new 2017 private tax collectors are reportedly off to a scandalous start.[13]

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[10] "Offshore Shell Games 2016: The Use of Offshore Tax Havens by Fortune 500 Companies," U.S. PIRG Education Fund and Citizens for Tax Justice and Institute on Taxation and Economic Policy, *http://ctj.org/pdf/offshoreshellgames2016.pdf;* "With Tax Break, Corporate Rate is Lowest in 40 Years," *Wall Street Journal,* February 3, 2012, B1.

[11] M. Carr Ferguson, "How to Save the Corporate Income Tax," *Tax Notes,* August 29, 2011 p. 951, 2011 TNT 167–6.

[12] "Hearing on Fiscal Year 2007 Appropriations for the Internal Revenue Service," House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, March 29, 2006, CQ Transcriptions.

[13] Tom Herman, "IRS Plans to Use Private Firms to Pursue Taxpayers This Year," *The Wall Street Journal,* June 21, 2006; "Details Emerge Over IRS Contract Winner," *WebCPA.com,* May 5, 2006; "The Gifting of New Jersey Tax Officials," State of New Jersey Commission of Investigation, December 2005; "Workers for N.J. enjoyed freebies," *Bergen Record,* December 21, 2005; "City's debt collector gets hefty share," *Richmond Times-Dispatch,* April 23, 2006. A pilot program for private debt collection was attempted under the Clinton administration, but failed.

Jon Talisman complained that administering health care reform was burdened on IRS without funding. One must appreciate how very resourceful IRS became in creative funding. The fee list that IRS publishes for issuing private letter rulings near the beginning of each year is supposed to be calculated in accordance with OMB Circular No. A–25. The first revenue procedure of each year lists most fees. For 2017, fees ranged from $2,400 to $28,300 (up nearly 400 percent since 2011). IRS simply raised user fees to pay for implementing Obamacare which Congress wouldn't fund. It's a violation of Circular A–25 rules on how fees are supposed to be set.

It is essential that Congress properly fund IRS.

Closing

Finally, in the entire hearing, I heard no mention of Ways and Means Chairman Dave Camp's 2014 Tax Reform proposal. That was the result of a three years study proposing to vastly simplify the income tax while broadening the base. It contains something for everyone to hate. Yet, it is a very coherent and comprehensive proposal for study and consideration in any income tax reform.

World War II Treasury Counsel, Randolph Paul was the architect of our modern income tax system, founder of the eminent law firm Paul Weiss Rifkind Wharton and Garrison, and a coauthor of *Merten's Law of Federal Income Taxation.* He had timeless advice regarding tax reform:

> The task of building a sound tax system will be hard and long. It is not a partisan job; it is not a task that will be completed by any one Congress. There will always be things left to do, if we have the wisdom to benefit by the new insight which experience can bring to open minds, and if our tax system is to fit the changing economic and social needs of each succeeding generation . . . the final compromise of all conflicting forces will be a tax system intelligently designed to make a continuously prosperous America.[14]

Pub. L. 104–52 (1995); "Contractors for IRS Are Accused of Abuses," *New York Times,* June 24, 2017.

[14] Randolph E. Paul, *Taxation for Prosperity* (Indianapolis, Bobs-Merrill Company, 1947), 418.