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INDIVIDUAL TAX REFORM

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INDIVIDUAL TAX REFORM

THURSDAY, SEPTEMBER 14, 2017

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

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Cornyn, Thune, Isakson, Portman, Toomey, Heller, Cassidy, Wyden, Stabenow, Cantwell, Nelson, Carper, Cardin, Brown, Bennet, Casey, and McCaskill.

Also present: Republican Staff: Tony Coughlan, Senior Tax Counsel; Chris Hannah, Tax Counsel; Alex Monie, Professional Staff Member; Martin Pippins, Detailee; Preston Rutledge, Senior Tax and Benefits Counsel; and Jeff Wrase, Chief Economist. Democratic Staff: Joshua Sheinkman, Staff Director; Michael Evans, General Counsel; Tiffany Smith, Chief Tax Counsel; and Adam Carasso, Senior Tax and Economic Advisor.

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. I want to welcome everyone here to this morning's hearing, where we will discuss a major piece of the tax reform puzzle.

Today will be talking about ideas, proposals, and considerations for reforming the individual tax system. While we have had countless hearings on tax reform in recent years, today's hearing is the first in what I hope will be a series of hearings leading up to an intensive effort of this committee to draft and report comprehensive tax reform legislation.

We have talked about these issues a great deal. In fact, since I became the lead Republican on this committee in 2011, we have had more than 60 hearings where tax reform was the main focus of the discussion.

I think we are capable and ready to get to work on producing a bill. And I look forward to working with my colleagues on this next, all-important stage of the process.

I would like to make a couple of points about that process for a moment, because there seems to be some confusion as to what the Finance Committee's role will be in tax reform. I have heard a lot of talk about a secret tax reform bill or a comprehensive plan being written behind closed doors.

Most of you have probably also heard about tax reform details that are set to be released later this month. True enough, leaders of both the House and the Senate, including myself, as well as officials from the executive branch have been discussing various proposals.

But as we stated in our joint statement before the recess, and as I have stated on numerous occasions, the tax writing committees will be tasked with writing the bill. This group—some have deemed us "The Big Six"—will not dictate the direction we take in this committee.

Any forthcoming documents may be viewed as guidance or potential signposts for drafting legislation. But at the end of the day, my goal is to produce a bill that we can get through this committee. That takes at least 14 votes, and hopefully we will get more.

Anyone with any experience with the Senate Finance Committee knows that we are not anyone's rubber stamp. If a bill—particularly on something as consequential as tax reform—is going to pass in this committee, the members of the committee will have to be involved in putting it together.

Therefore, I intend to work closely with my colleagues and let them express their preferences and concerns so that when we are ready to mark up a tax reform bill, the mark will reflect the consensus views of this committee. That work, in many respects, has already begun, and we are well on our way.

I will note that I have not limited these commitments to my Republican colleagues on the committee, which brings me to my second point. From the outset, I have made clear that my preference is to move tax reform through this committee with bipartisan support. I have no desire at all to exclude any of my Democratic colleagues from this discussion, and I am not determined to report anything by a party-line vote.

I will note that the President and his team have publicly said the same thing this week. If any of my Democratic colleagues are willing to come to the negotiating table in good faith and without any unreasonable preconditions—and I believe they are—I welcome their advice and input.

So far, my colleagues have insisted that the majority agree to a series of process demands before any substantive bipartisan talks can take place. Effectively, they want to ensure that we make it easier for them to block the bill entirely before they will talk about what they want to put in the bill.

Now that seems kind of counterintuitive to me. And in my view, it is unreasonable. Furthermore, I do not recall either side ever offering such a concession when they were in the majority. We should not let the process concerns keep us from talking about the substance of a tax reform bill. And my hope is that my colleagues on the other side will put these demands aside and let us begin searching for common ground on these important issues.

Those threshold matters aside, let me talk about today's hearing. One argument that rears its ugly head in every tax reform debate is the claim that proponents of reform want to cut taxes for the uber-rich and give additional tax breaks to greedy corporations.

We have heard that argument repeated in the current debate, and while these claims are about as predictable as the sunrise, they are simply not true. While I cannot see into the hearts of every member of the Congress, I truly do not know of a single Republican who, when thinking about tax reform, asks themselves what they can do to help rich people. That has never been our focus, and it is not our focus now.

In fact, an argument can be made that the other side has helped the rich more than we have. Instead, we are focused squarely on helping the middle class, and recent proposals to reform the individual tax system reflect that.

For nearly a decade now, middle-class families and individuals have had to deal with a sluggish economy, substandard wage growth, and a growing detachment from labor markets. Tax reform, if it is done right, can help address those problems and provide much-needed relief and opportunity for millions of middle-class families.

That, once again, is our goal in tax reform. It is, in fact, the driving force behind our efforts.

Let us talk about a few specific proposals. Under our tax code, individual taxpayers or married couples can opt to either take the standard deduction or itemized deductions to lower their tax burden. Currently, about two-thirds of all U.S. taxpayers opt to take the standard deduction. These are often low- to middle-income taxpayers.

One item that has been central to a number of tax frameworks is a significant expansion of the standard deduction, which would reduce the tax burden for tens of millions of middle-class families and eliminate Federal income tax liability for many low- to middle-income Americans.

I will note that this is not only a Republican idea. In fact, a few years back our ranking member introduced legislation that would have nearly tripled the standard deduction. And I commend him for it. This is the very definition of middle-class tax relief, and it goes beyond direct tax and fiscal benefits.

With a significantly expanded standard deduction, the tax code would immediately become much simpler for the vast majority of middle-class taxpayers. And that is no small matter.

Currently, American taxpayers, both individuals and businesses, spend about 6 billion hours—that is with a "b"—and nearly a quarter of a trillion dollars a year complying with tax filing requirements. This, of course, is not surprising given that our tax code has grown exponentially into a 3-million-word behemoth that is basically indecipherable for the average American.

That one change, expanding the standard deduction, would let millions of middle-class taxpayers avoid having to navigate the treacherous landscape of credits and deductions. Combined with other ideas, including a significant reduction in the number of credits and deductions in the tax code and a radically simplified rate structure, this approach will save middle-class families both time and money.

I expect there to be some disagreements about what credits and deductions to keep and which to repeal in the name of tax simplicity, efficiency, and of course, fairness. I expect we will air some of those differences of opinion here today.

There are other tax reform proposals under discussion that will help the middle class. For example, an increase and enhancement of the Child Tax Credit would benefit middle- and lower-income families almost exclusively. And by reducing barriers and disincentives for savings and investment, we can expand long-term wealth and improve the quality of life for those in the middle class.

Now these are some of the central ideas being discussed to reform the individual tax system. And in virtually every case, the primary beneficiaries of these proposals would be middle-class taxpayers.

I know that there are Democrats who support these types of reforms. As I mentioned earlier, I hope we can recognize this common ground and find ways to collaborate in the broader tax reform effort.

I will also note that the middle class has a significant stake in our efforts to reform the business tax system, but that is a matter for another hearing.

Once again, this committee has a lot of work to do. There is not going to be a top-down directive that makes the hard decisions for us. I know we are up to that task, and most of us are game to participate in the process to help us reach a successful conclusion.

Now, before I turn to my distinguished counterpart, Senator Wyden, I want to say that I hope we can have a productive discussion of options to reform taxes for individuals and not a debate on so-called "plans" based on outside analysts' conjectures and assumptions. It is all too common for ideological think tanks or partisan analysts to take short statements outlining broad principles on tax reform and then fill in the gaps with their own subjective assumptions about details just to parade out a list of horribles that they then use to tarnish the entire reform effort.

Let us discuss real ideas and proposals, keeping in mind that the Finance Committee will not be bound by any previous tax reform proposals or framework when we start putting our bill together.

With that, I am going to turn to my friend and colleague, Senator Wyden, for his opening statement, and then we will go from there.*

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

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

Senator WYDEN. Mr. Chairman, thank you very much, and let me state again how much I value our partnership. We showed that again this week with the beginning of the effort to deal with children's health.

Obviously, we have a long way to go in the committee process, but I want it understood that I very much value this partnership. And I think I can speak for all of the Senate Finance Democrats—we share the view that the tax system in this country does not work for millions of Americans, particularly working-class people who drive this economy. Seventy percent of the economy is their consumer spending. So we very much feel that the tax code in this country is broken.

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*For more information, *see also*, "The Taxation of Individuals and Families," Joint Committee on Taxation staff report, September 12, 2017 (JCX–41–17), *https://www.jct.gov/publications.html?func=startdown&id=5020.*

Now just yesterday, the President declared to the Nation that his tax plan would not give any breaks to the wealthy. That was yesterday.

But the fact is, today the President's one-page tax outline has a new lunar crater-sized loophole for the wealthy that would allow them to abuse what is called a tax pass-through. The tax pass-through concept is supposed to be about helping the small business folks.

But the Trump plan turns it into a scheme for letting the wealthy dodge paying their fair share. In effect, they get to take ordinary income and convert it into long-term capital gains income—paying 15 percent. So they get a big break and they avoid paying their Social Security and payroll taxes.

So in spite of what the President said yesterday about not wanting to have tax breaks for the wealthy, you can look today at the one-page tax outline and you can see a huge new break there for the very wealthy. And that is, colleagues, on top of the administration's commitment to abolish the estate tax, which touches only one out of every 500 wealthy estates. That too is an outlandish giveaway to people at the top.

Now with respect to this whole notion about "The Big Six"—and I appreciate the chairman's comments—it was only a few weeks ago where pictures were being sent by the group around the country to say, "We are writing this tax bill." This did not come from me or from a Democrat. These pictures were sent around the country from "The Big Six," saying that they were writing this bill behind closed doors.

So what we Finance Democrats have said—and overwhelmingly our Democratic colleagues—is that there are key principles that we feel strongly about. We feel strongly about having the regular order so that members on both sides can offer their ideas and their amendments and not have a partisan reconciliation process.

We feel strongly about fiscal responsibility. We want a deficit-neutral plan. We want it to be as progressive as current law, which means you are not doling out new breaks for the 1 percent.

And I share the chairman's view with respect to talking about real ideas, and I would just like to note as we do that, what President Reagan did in 1986 is, he said there would be equal treatment with respect to income earned by a wage earner and income earned by somebody who is in financial services. So if anything, what Ronald Reagan stood for went beyond, colleagues, the principles that we Democrats have staked out.

So if you listen to the talking points, you hear a lot about how the Trump plan would put a big focus on the burden of complexity the tax code heaps on so many middle-class families. But if you look at the architecture, again, of what the President has laid out, it does not reduce complexity or focus on the middle class. It endows future generations of the mega-wealthy.

Now, I am just going to conclude my remarks by saying there is a blueprint for bipartisan comprehensive tax reform that works, and it is picking up on some of the ideas of the late President Reagan. And it is certainly not what is being pursued by the President as of right now.

Republican Reagan-style tax reform fights complexity by fighting unfairness. As I mentioned, 31 years ago President Reagan signed a bill that equalized the tax treatment of wages and wealth. What that means is that a worker who punches a clock going in and out every shift is not getting a raw deal compared to a trust fund baby.

Reagan-style tax reform is about cleaning out tax deadwood, the provisions that do a whole lot more to please special interests, and what amounts to all of the lapdogs they have who are trying to come up with new ways to carve out special breaks for people at the top.

Those are propositions that I believe ought to get a lot of bipartisan interest again today. And the reason I say that is, the tax code, colleagues, in America is a tale of two systems.

There is one set of strict rules for a cop and a nurse who are married and they are raising kids. Their taxes come out of every single paycheck; no special dodges, no special schemes for the cop or the nurse to exploit.

Then there is a whole other set of rules for the most fortunate. It says they can decide how much to pay and when to pay it. And as I said, as of today, in spite of the President's comments yesterday that he did not want to help the rich, that tax outline creates another lunar crater-sized loophole for the wealthy to exploit.

That is the brand of unfairness that President Reagan said he was going to go after. So, tax reform in 2017 ought to be an opportunity to put money back into the paychecks of the cop and the nurse and working families who are saving for retirement, to pay for college, and affordable housing.

And that is why I think it is constructive that the chairman is open to ideas for how we pursue it. The basic proposition that President Trump has on offer goes after middle-class tax benefits like the State and local deduction and incentives for retirement savings and home ownership. And it gores working families to finance these special breaks, these special breaks that as of today are still on the Trump tax outline for the most fortunate and the biggest corporations.

When it comes to this whole issue of the State and local deductions, this is fake tax reform. This is not just a play at taking away from the blue States. There are middle-class families all across America. They are in deep blue areas that went for Clinton and scarlet red areas that went for President Trump, and they will be taxed twice on the same income if State and local deductions are eliminated. The dreaded double taxation—if you are opposed to it when it involves corporate income, you cannot line up behind a plan to double tax middle-class families twice as hard on their hard-earned pay. That is what this issue is about.

When it comes to simplification, it is easy to hold up a proposal to double the standard deduction as evidence you want to make a filing easier. I appreciated the chairman's kind words that quite some time ago with several Republican colleagues—most recently a member of the President's Cabinet, Dan Coats, who sat right there where Senator Cassidy is sitting—I advocated tripling the standard deduction. You triple the standard deduction for a worker in Michigan or any of our States, and the first thing that happens is immediately those folks will adjust their withholding. We will put hundreds and hundreds of dollars of real tax relief into the pockets of working-class families right away.

The President's plan gives those folks no crumbs, using the most partisan approach, which is known as reconciliation.

I am looking forward to hearing from our witnesses. Mr. Chairman, again, I want to express my gratitude for our friendship. We have worked together on a lot of things. I guess it is called being in a legislative foxhole or something like that.

You really worked hard to reach out to me. We Democrats have laid out core principles that I have described today that frankly do not even go as far as what the late President Reagan did when he worked on tax reform in 1986. So I look forward to pursuing this conversation with you in the days ahead and hearing from our colleagues.

The CHAIRMAN. Well, thank you, Senator.

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

The CHAIRMAN. I would like to welcome each of our four witnesses to our hearing today. Before we begin, I want to thank each of you for your work and your willingness to testify and answer questions. Your work on this important issue is very important to us. We all look forward to hearing each of your perspectives on tax reform.

First, we are going to hear from Mr. Alex Brill, a resident fellow at the American Enterprise Institute, AEI. Before joining AEI, Mr. Brill served as the Policy Director and Chief Economist for the House Ways and Means Committee. Previously, he served on the staff of the White House Council of Economic Advisors. He has served on the staff of the President's Fiscal Commission, also known as Simpson-Bowles, and the Republican Platform Committee. Mr. Brill has an M.A. in mathematical finance from Boston University, and a B.A. in economics from Tufts University.

Next we will hear from Ms. Iona Harrison, the current chair of the Taxation Committee of the National Association of Realtors. Ms. Harrison was born in San Juan, PR and currently resides in Maryland. Ms. Harrison has been a licensed realtor since 1976 and previously served as the president of the Maryland Association of Realtors. She attended Georgetown University and received a B.S. in history from the University of Maryland.

Our third witness will be Ms. Lily Batchelder, a professor of law and public policy at the NYU School of Law and an affiliated professor at the NYU Wagner School of Public Service. From 2010 to 2015, she was on leave serving as the Deputy Director of the White House National Economic Council and Deputy Assistant to the President, and as majority chief tax counsel for the U.S. Senate Committee on Finance.

Before joining NYU in 2005, Ms. Batchelder was an associate for Skadden, Arps, Slate, Meagher, and Flom, prior to which she also worked as the director of community affairs for a New York State Senator and also as a client advocate for a small social services organization. Ms. Batchelder received an AB in political science from Stanford University, an MPP in microeconomics and human services from the Harvard Kennedy School, and a J.D. from Yale Law School.

Finally, we will hear from Ramesh Ponnuru, a senior editor at *National Review,* where he has covered national politics and policy for more than 20 years. He is also a columnist for *Bloomberg View,* which syndicates his articles in newspapers across the Nation.

He is a visiting fellow at the American Enterprise Institute, and he serves as a contributing editor to *National Affairs.* In 2015, Mr. Ponnuru was included in the *Politico* 50. He grew up in Kansas City, KS and graduated from Princeton University.

I want to thank you all for coming today. Mr. Brill, we will begin with you, if you will please get us started by providing us with your opening remarks.

STATEMENT OF ALEX M. BRILL, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Mr. BRILL. Chairman Hatch, Ranking Member Wyden, and other members of the committee, thank you for the opportunity to testify this morning. My name is Alex Brill. I am a resident fellow with the American Enterprise Institute.

I commend the committee for holding this important and timely hearing because of the opportunity for fundamental and comprehensive tax reform. It is before this committee for the first time in many decades.

While the tax code has frequently and sometimes significantly changed over the last 30 years, not since 1986 has it been truly reformed in a manner that sought to broaden the base and lower statutory tax rates. The last 30 years have seen tax complexity increase dramatically with the introduction of more and more tax expenditures. In many regards, the tax code today imposes unnecessary and undue burdens on families and individuals.

Reversing this trend of the last 3 decades and pursuing individual income tax reform means a broader base and lower statutory tax rates. Such a reform will yield a more neutral and a more efficient tax code, one that will facilitate a more productive allocation of resources, and if pursued in conjunction with business tax reform and without impeding savings, this can contribute to a pro-growth economic environment.

My written testimony, which I have submitted for the record, makes five points which I would like to briefly summarize. First, as I just noted, the current individual income tax system is complex. It is burdensome. It is riddled with deductions, exclusions, and credits. Appropriately broadening the tax base can mean meaningfully simplifying the tax code, especially for many in the middle class.

Second, and often under-unappreciated, is the fact that the current individual income tax system often treats taxpayers with similar amounts of similar income very differently. Appropriately broadening the tax base can be an effective means for correcting this disparity known as "horizontal inequity" in the tax code.

For example, nearly 20 percent of taxpayers, one in five who report about $36,000 in adjusted gross income, pay a higher average tax rate than 60 percent of taxpayers who earn $50,000.

Third, in addition to contributing to complexity and horizontal inequity, itemized deductions are generally regressive tax policies. The deduction for State and local taxes is an excellent example of this. It is a policy that, while regressive at the Federal level, ironically incentivizes States to pursue more progressive, but more inefficient tax policies. I estimate that this tax provision forgoes $1.4 trillion over the budget window in revenue, providing subsidies to certain taxpayers in certain States.

Fourth, broadening the tax base, particularly with regard to limiting itemized deductions, is an opportunity to move towards a more neutral tax code, one that interferes less in the allocation of resources—decisions that are often best left to the free market.

My final point is on tax policy and transition, the transitionary path from the tax code we have today to a fairer, simpler, hopefully more pro-growth tax system. That process is itself a complex challenge, one that will require lawmakers to strike a careful balance. Inadequate or insufficient transition relief will cause some taxpayers to face steep and unanticipated tax burdens; but conversely, overly extended and generous transition relief may limit the potential economic gains from tax reform.

In conclusion, lawmakers have the opportunity to simplify the tax code, improve the horizontal equity of the system, and reduce economic distortions. Tax reform that wisely broadens the tax base can achieve these goals. To pursue the additional core objective of a tax reform that promotes economic growth, lawmakers should look to reduce if possible—and certainly not increase—the current tax penalty on savings.

Thank you, and I would be happy to answer your questions.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. Ms. Harrison, we will turn to you now.

STATEMENT OF IONA C. HARRISON, SENIOR VICE PRESIDENT, PIONEER REALTY, UPPER MARLBORO, MD

Ms. HARRISON. Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for this opportunity to testify on behalf of the more than 1.2 million professionals who belong to the National Association of Realtors.

As with most Americans, Realtors agree that a major result of tax reform should be simplification. But simplification does not necessarily equal elimination. From its inception, our tax system has featured easy to comply with housing incentives utilized by tens of millions of Americans.

For decades, these have helped facilitate home ownership, build wealth, and provide stability to families and communities. NAR believes that tax reform that eliminates or weakens the current-law tax incentives for purchasing or owning a home would be shortsighted and counterproductive to a strong economy and healthy communities. My written testimony outlines the reasons why in detail, but I would like to focus on three major points.

First, the deduction for State and local taxes is vital to a sound tax system. This deduction is so basic that its origins go back to the Income Tax Act of 1861, and Federal income tax statutes since then have included it. State and local taxes paid to benefit the general public are similar to the Federal income tax in that they both fund central government services.

Allowing a Federal deduction for them is essential to avoiding double taxation on the same income. Paying involuntary levies such as taxes is tantamount to the money having never been earned in the first place. So where is the justification for taxing it?

Some suggest the deduction be repealed because it subsidizes State and local governments, leading them to increase spending. Interestingly, few if any, suggest that the far more generous credit for taxes paid to a foreign government subsidizes spending by those nations or encourages profligacy by them.

Second, the mortgage interest deduction, MID, is a key incentive to purchasing a first home and building home ownership in our society. Critics often pan the MID as benefitting primarily the rich. In reality, the deduction is utilized by households of all incomes. Fifty-three percent of those claiming the MID in 2015 earned less than $100,000, and 85 percent had a GI of less than $200,000.

It is important to recognize that the value of the current tax benefits of owning a home, including both the MID and the property tax deduction, are embedded in the price of a home. If those benefits are removed, the value of homes drops.

Some suggest lowering the MID cap from $1 million to $500,000. Realtors oppose this idea. A $500,000 cap would be unfair to those living in high-cost areas, many of whom are by no means rich and have fairly modest homes.

Also, inflation could make the pinch of a lower cap much more universal in just a few years. Remember the alternative minimum tax and what happened when it was not indexed? NAR calculations show that by 2043, the value of more than half the homes in a majority of States will likely be greater than $500,000.

Third, and most importantly, a tax reform plan like the House Blueprint, which doubles the standard deduction while eliminating most itemized deductions, would bring minimal simplification at a very high price for many homeowners and especially those with larger families. The combination of the larger standard deduction and the repeal of the State and local tax deduction would wipe out the incentive value of the tax benefits of owning a home for all but the most affluent.

Essentially, owning and renting a home would be equivalent for tax purposes for 95 percent of filers. This would drop the value of homes, wrenching the economy.

Also, many homeowners would pay more tax under such a plan, while most renters would get tax cuts. Part of the reason is that the Blueprint repeals dependency exemptions to help fund the increased standard deduction.

The increased child credit helps offset part of this loss, but not for larger families or with children older than 16. The effect could be particularly acute in States like Utah where families are larger, home ownership is higher, and itemized deductions are greater than average.

Tax reform that penalizes American homeowners and middle-class families in the name of simplification or lower corporate rates is not worthy of the name. Smart tax reform must first do no harm.

Thank you.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Ms. Batchelder?

STATEMENT OF LILY L. BATCHELDER, PROFESSOR OF LAW AND PUBLIC POLICY, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

Ms. BATCHELDER. Good morning, Mr. Chairman, Ranking Member Wyden, and members of the committee. My name is Lilly Batchelder, and I am a professor at NYU School of Law. Thank you for the opportunity to testify before you today on the important topic of individual tax reform. It is an honor to be back with the committee.

My testimony makes five main points. First, the current tax reform effort is occurring at a time when low- and middle-income families are facing deep financial challenges. Economic disparities are vast and have been widening for decades.

The U.S. actually has one of the lowest levels of economic mobility relative to our competitors. Our debt as a share of GDP is projected to grow to unprecedented levels in coming decades, largely because of the retirement of the baby boomers and increasing life expectancy. This growth in debt will be a drag on economic growth.

For all these reasons, tax reform should increase revenues and should increase progressivity. Doing so would boost economic growth and make the tax code fairer at the same time. At a bare minimum, tax reform should maintain the current level of revenues and progressivity. And these both should be measured consistently and without resort to budget gimmicks like a current policy baseline.

Second, individual tax reform should focus on leveling the playing field for the next generation and supporting work. Doing so would blunt economic inequality, broaden opportunity, and increase productivity by ensuring that jobs are awarded more often based on effort and talent and less based on connections and the luck of one's birth.

Some worthwhile proposals that would advance these goals are expanding the EITC, especially for workers without dependents; increasing refundability of the Child Tax Credit, particularly for young children in the poorest families; and restructuring child care benefits to provide the largest benefits to those spending the largest share of their income on child care.

These proposals could make significant headway in offsetting the much lower earnings growth that working-class families have experienced over the past few decades compared to those who are more fortunate. They should be paid for by raising taxes on the wealthy, including by strengthening and not repealing the estate tax.

Third, individual tax reform should focus on reducing transactional complexity, which essentially involves eliminating opportunities for savvy taxpayers to game the system. This would accomplish the trifecta of tax reform: making the tax code fairer, more efficient, and simpler.

To further this goal, I urge the committee to consider proposals like rationalizing the NIIT and SECA taxes so all labor and capital income is subject to the Medicare tax on high incomes in some form, repealing stepped-up basis, narrowing the gap between the tax rates on ordinary income and capital gains, and taxing carried interest as ordinary income.

Fourth, individual tax reform should seek to make tax incentives more efficient and fair, generally by restructuring them into refundable credits and leveraging the empirical findings of behavioral economics. Doing so could generate more social benefits at a lower cost. And one particularly promising area for reform is tax incentives for retirement savings.

Finally, the very first principle of tax reform should be to do no harm. Unfortunately, the tax plans offered so far by the President and the House Republican Blueprint do just that: they lose massive amounts of revenue. The corresponding increase in the debt would depress economic growth substantially over time.

They are both sharply regressive, providing vast tax cuts to the wealthy and a pittance for everyone else. They create a giant new loophole for the wealthy in the form of a special rate cap on pass-through business income, which tax experts on the left and right agree is a terrible idea.

And to the extent that they include any proposals intended to benefit low- and middle-income households, they do so in a relatively ineffective way. Sooner or later, these plans' massive tax cuts for the wealthy will have to be paid for, and low- and middle-income families are likely to be left footing the bill.

I, therefore, urge the committee to consider a fundamentally different approach.

Thank you for the opportunity to testify, and I look forward to your questions.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Mr. Ponnuru?

STATEMENT OF RAMESH PONNURU, VISITING FELLOW, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Mr. PONNURU. Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, thank you for convening this hearing and inviting me to testify. My name is Ramesh Ponnuru. I am a visiting fellow at the American Enterprise Institute, a senior editor at *National Review,* and a columnist for *Bloomberg View,* although my testimony reflects my views alone and not those of any organization with which I am affiliated. It is an honor to be testifying today.

While tax policy has been politically contentious, I am here to discuss a unifying issue. Over the last 20 years, a broad political consensus has supported tax relief for parents of dependent children. The major reforms of the tax code undertaken over this period have consistently, without exception, included such tax relief.

People from different parts of the political spectrum have had varying reasons for supporting the child credit, including an appreciation of the costs of raising children and the belief that raising children is in no merely metaphorical sense an investment in the Nation's future. The fact that the child credit lifts nearly 3 million people out of poverty each year has also brought it support.

What is not always appreciated is how the child credit advances a major goal of tax reform, creating a tax code that raises the desired amount of revenue while minimizing the distortions that government policy can create. A familiar example of a distortion is an unjustified tax break. Tax reformers seek to curtail such tax breaks because they unfairly enrich some groups to the detriment of others, and they inappropriately encourage some activities over others.

The child credit advances this goal by reducing a distortion caused by government policy: the large, though implicit, tax on parenting that the structure of some of our largest Federal programs has inadvertently created. It is, of course, true that all taxpayers, whether or not they have children, contribute to Social Security and Medicare, but the financing of those programs relies in a special way on parents. They contribute to the programs, both through the Federal taxes that they pay and through the financial sacrifices that they make to raise children, including in many cases forgone income.

Because the Federal Government does not recognize the extent of their parental contributions, parents shoulder a larger share of the burden of government than they should. In the world before these programs, many of the financial sacrifices parents made redounded to their direct benefit in old age as their children took care of them.

Now much of that age-old financial return on parents' investment in children goes to senior citizens as a group, whether or not they themselves raise children. That is a shift that we as a society have made for very weighty and extremely widely supported reasons, but the shift has had the inadvertent effect of transferring resources from parents of the childless and from larger families to smaller ones. We can call this transfer the "parent tax."

Some government policies offset this parent tax, notably, the tax exemption for dependents and the existing tax credit for children. But the level of the tax remains quite high even after these policies. One conservative estimate suggests that the child credit would need to more than quadruple to eliminate the parent's tax completely.

A credit that large is unrealistic, but the calculations suggest that tax reform should—whatever its other parameters—include an expansion of the child credit so as to reduce the share of the overall tax burden paid by parents. It suggests as well that the expansion should take two forms. The maximum value of the credit should be raised from $1,000 per child to some significantly larger number, and the credit should be applied against payroll taxes as well as income taxes.

Finally, it suggests that if the dependent exemption declines as part of tax reform, the expansion of the child credit should be large enough to more than make up for that decline. A Child Tax Credit expansion compares favorably to other proposals for middle-class tax relief, such as an increased standard deduction.

The larger child credit would reduce the parent tax distortion, while the standard deduction would not. In addition, a larger share of the benefits of a child credit expansion would accrue to relatively low-income households. An expanded Child Tax Credit for children should be part of a larger tax reform that Congress enacts so as to ensure that tax reform is both pro-growth and pro-family.

Thank you for the opportunity to testify, and I look forward to your questions.

The CHAIRMAN. Well, thank you so much.

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

The CHAIRMAN. We will now open this up for some questions.

Ms. Batchelder, a significant part of your written testimony is spent on suggestions on how to make the tax code more progressive; that is, in how to make the rich pay more tax and the poor pay less tax.

So my question is this: would repealing the Federal itemized deduction for State and local income taxes be a shift in a progressive direction? And after Ms. Batchelder, if Mr. Brill would briefly weigh in on this too, I would appreciate it.

Ms. BATCHELDER. I think it really depends on how that revenue is used. So in the current proposals by the President and the House Republican Blueprint, the revenue from repealing the State and local tax deduction is used for highly regressive tax cuts. So on net, it would make the tax code less progressive.

And if you repealed the State and local tax deduction in isolation and used that revenue, for example, to expand the Earned Income Tax Credit or the Child Tax Credit, that would be a progressive change. But it really depends on what you are using that revenue for.

The CHAIRMAN. Mr. Brill?

Mr. BRILL. Senator, I would say that the repeal of the State and local deduction is a progressive change in isolation by itself. It is true that in the context of fundamental reform, we would have to look at all the fundamental pieces and where all the changes are made, but that piece by itself would be a step in making the tax code more progressive.

The CHAIRMAN. Okay.

Well, let me ask this of Ms. Harrison. In your written testimony, you write extensively about how the State and local tax deduction for real property taxes is mostly a benefit for the middle-class. And we have statistics from the Joint Committee on Taxation demonstrating that the vast majority of the benefit of the State and local tax deduction for State and local income taxes goes to persons with an income exceeding $200,000 per year.

So it appears that there is a real difference between who benefits from the deduction for real property taxes, and who benefits from the deduction for State and local income taxes. Am I right on that? And also, am I correct in stating that your testimony is much more focused on preserving the deduction for real property taxes than it is on preserving the deduction for State and local income taxes?

Ms. HARRISON. While not being a tax expert—and I want to get that caveat out right from the inception—my information in the written testimony was based primarily on our PricewaterhouseCoopers study. As with the mortgage interest deduction, I would say that my figures are that 75 percent of the value of real property tax deductions in 2012, for instance, went to taxpayers with cash incomes of less than $200,000, and that the typical real estate tax deduction beneficiary has an adjusted gross income of slightly less than $81,000, which I think, again, is squarely in the middle class.

So one of the other reasons that we want to maintain this as a source of home ownership is that for many homeowners this is a mandatory, obvious tax that they pay throughout their life. When their mortgage is paid off, they are no longer getting the benefit of the mortgage interest deduction, if they took it, but they will continue to be able to utilize the deduction they pay for State and local taxes throughout their ownership of that property, if they so choose.

Once again, we want to refer one back to the idea that because of the standard deduction, many people who are homeowners get the benefit of that standard deduction as part of that taxing that takes place at that level. The idea, I assume, of a standard deduction is to allow people to keep a portion of their earned income discretionary because they have already paid it in taxes.

The CHAIRMAN. Okay.

Mr. Ponnuru, you suggest a much higher Child Tax Credit. And as you acknowledge, this will cost a lot in the 10-year window, and so in the 10 years, this would be difficult to pay for.

But I suppose one of your points is that it will largely pay for itself in the long run; that is, today's children will be tomorrow's Social Security taxpayers. Am I right about that?

Mr. PONNURU. Thank you for your question, Mr Chairman. I think that I do not propose that the budget should account for such long-term effects in financing an expansion of the child credit. I propose that an expansion of the child credit be financed in the way that other forms of tax relief are, with the familiar list of payfors that I am sure that all of you are extremely familiar with.

I would just point out that whatever proportion of a tax cut is paid for with tax increases or spending cuts elsewhere, we should be consistent, and a child credit should not be treated any differently than other forms of tax relief.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman.

Welcome to all of you. And, Ms. Batchelder, it is very good to see you. It was not very long ago when we enjoyed having you on this side of the dais and I was sitting down there somewhere beyond where Michael Bennett is now. So we are glad to have you.

As I indicated, times are different—2017 is different from 1986 when Democrats and Ronald Reagan got together. But the principles of tax fairness are there for the ages.

And I would like you—if you would, for my opening question—to contrast what the President said yesterday, where he said there are not going to be any tax breaks for the very wealthy, the people at the top, with what is on offer as of this morning from President Trump.

Ms. BATCHELDER. Thank you for the question. It is a pleasure to be back with the committee and fun to be on the other side of the dais.

I tend to believe people based on their actions and not on their words. And so, I think when you look at the President's statement yesterday where he is saying that he will not cut taxes for the wealthy, it is hard to square, to say the least, with the plans that he has put out.

He has put out different iterations of his plan. They have all been estimated by nonpartisan organizations, and I cannot think of a single credible analysis of any of his plans that finds that they do not cut taxes substantially for the wealthy and are regressive overall.

So, if you look at his plan overall, it includes huge tax cuts for the wealthy. The top 1 percent gets about half the value of the tax cuts in his plan. I tend to think of the best way of looking at the distribution of tax changes as a percentage change in after-tax income, and the top 1 percent gets a boost in their after-tax income of 12 to 13 percent, versus 0 to 2 percent for the vast majority, 80 percent of low- and middle-income families.

In addition, his plan raises taxes, actually, on millions of families.

Senator WYDEN. On working families.

Ms. BATCHELDER. Working families, yes.

So an astonishing 45 percent of families with children are estimated to face a tax increase immediately in 2018 under his plan, and 70 percent of single parents. And he has known this. This has been in the press since last year. I find it very surprising that he has not chosen to fix the plan and address these tax increases in the midst of a plan that overall is reducing revenues by trillions of dollars.

The last thing I would say is, sooner or later that trillion-dollar revenue loss—that is $3.5 trillion according to the most recent estimates—is going to have to be paid for. Right now it appears that he is proposing to deficit-finance it. His budget plans would potentially reduce entitlements and other spending in ways that would hurt low- and middle-income families.

But even if those spending cuts were not passed now, it is very likely in the future that low- and middle-income families would be left holding the bag in the form of either tax increases or spending cuts to——

Senator WYDEN. It is a very important point you make, that these errors that they have said they have made have not been corrected. That has been the case with the outrageous pass-through provision, which is a huge gift to the super-wealthy. And it is correct with respect to the working families who get hurt, which they said they did not want to see happen in tax reform, but the fact is they have said for months that they would correct it. It has not been done as of today. Words matter. Yes, deeds matter even more.

Mr. Ponnuru, just a question for you on this question of the Child Tax Credit. As you know, the committee made this permanent. We feel strongly about it. We would like to do everything we can to help working families.

I was pleased about a part of your answer to the chairman, where you basically rejected dynamic scoring. The chairman got into this question of, how are you going to pay for it? Then you said, hey, look, you have to pay your bills in the real world. We are not going to have some dynamic scoring. So I am pleased about that, and to have a conservative make that point is especially welcome.

The second point is—and I have read your articles and know that you think down the road about these issues. You said, okay, we will pay for the expansion—which I would certainly like to see—and for helping working families. We will do it by changes in Medicare and Social Security.

And what we have tried to do around here is to update the Medicare guarantee, and particularly, look at chronic illness and the like. It is going to take a lot of money to do what you are talking about with respect to the Child Tax Credit.

How would you go about finding the revenue? I mean, we would like to start closing some of these outrageous tax loopholes at the top. I did not see that in your statement, but we welcome your thoughts on it.

Mr. PONNURU. Thank you for providing me the opportunity to clarify. I support dynamic scoring, but I——

Senator WYDEN. You did not use it with respect to your answer to the chairman.

Mr. PONNURU. I support the idea of dynamic scoring. I do think that, in particular, when you are talking about the Child Tax Credit expansion, the possible revenue payoffs are so far in the future that it becomes even more subject to uncertainty than the usual exercise in dynamic scoring.

I have my own preferences as to how tax reform should be financed. My main point in this testimony has been to discuss the idea that part of the tax structure should be a positive change for parents regardless of what other choices the Congress makes.

My own views on how to finance these tax reforms, though, would include some long-term restructuring of entitlement programs, as I mention in my written testimony. I do also think that certain revenue pay-fors, such as a scaling back or elimination of the State and local deduction, scaling back of the mortgage interest deduction, would make sense.

And then finally, I also believe that expanding the width of the top tax brackets so that high-earning individuals pay the top rate on a larger percentage of their income also makes sense as a revenue raiser in a balanced package.

Senator WYDEN. I am over my time, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Isakson?

Senator ISAKSON. Thank you, Mr. Chairman. I want to assure Senator Cornyn and the other members to my left that I am not using my back situation as an advantage in my seniority, but I was here first. [Laughter.]

Thanks for letting me move over.

Mr. Brill, in the last tax act of 1986, I was in business. One of the most serious negative effects—and I was all for the 1986 tax act, by the way—but one of the most significant negative effects of it was the clawback on passive loss. And when the Congress did away with passive loss against earned income retroactively, it actually put a number of people out of business and created the real estate investment trust, because everybody had to go to the stock market to raise capital to get their balance sheet in order.

Your testimony, if I am not mistaken, addresses that and—not specifically that case, but a case of not clawing back. Do you agree or disagree that we should avoid any clawback on existing tax treatment that was made on investment prior to the time the tax law was changed?

Mr. BRILL. Thank you, Senator. I think that the transition issues, as I mentioned in my opening statement, are very important and can be very tricky. And in particular, the question that you are relating to of retroactive changes that raise taxes on decisions that have previously been made under a prior set of policies is one that can damage the confidence in the tax code.

If investors, small business owners, see a risk that tax changes can be made retroactively, that is only going to be a drag on their willingness to be entrepreneurial and to make new investments. The proper transition relief is, sort of, a provision-by-provision question.

But as a general matter, we want to make these changes on a prospective basis as we make new tax policy.

Senator ISAKSON. And that was my point. I read that in your testimony, and prospective is the way to look at these things.

We have a tendency as politicians to label things either progressive or liberal, or wealthier or conservative, or whatever. And sometimes we act on a label and we do not act on common sense. But it is only common sense to tell the American people that if we are going to tax you on investments you made in 2008, we are not going to change that in 2012 and come back and make it a different tax rate.

Once somebody has made an investment decision based on a tax code that applies to their investment of that time, that ought to stick, period. I think the same would be true for the internal build-up of dividends and generating life insurance, many other types of things that are longitudal investments like that. It is very important that we not do it.

The second thing—one of the things I have worked hardest on in this committee is incentives for Americans to save for their future. I think the best thing we can do to protect our republic in the long term is see to it that Americans can take care of themselves as much as the government can take care of them, or more so if possible.

Do you consider a deferral of tax liability, for example on an IRA investment or something like that, a benefit to the rich or do you think it a common-sense incentive for the tax code?

Mr. BRILL. Thank you, Senator.

Obviously, the tax code has a series of provisions related to savings, and the Joint Committee and the Treasury Department will identify these policies as tax expenditures. However in a technical sense they may be, these are policies that promote savings, which is critical for the long-term viability and economic growth of our country.

And income tax is by its very nature going to discourage future savings by its design. And these policies that promote individual savings—401(k) plans, IRAs, as well as policies that just promote savings generally—are all things that can lead to long-term positive economic growth.

Senator ISAKSON. And eventually, in the long-term investments that are tax-deferred, like an IRA investment that someone might make, eventually the revenue is going to be paid by the taxpayer when they withdraw the money. Is that not correct?

Mr. BRILL. That is absolutely correct.

Senator ISAKSON. Which also applies, I think, Ms. Harrison, to 1031 exchanges. Is that not correct?

It is not a matter of not collecting the tax, it is a matter of the timing of the collection of the taxes. Is that right?

Ms. HARRISON. Absolutely. And 1031 exchanges, again, are utilized throughout my profession, not just by practitioners who do massive commercial deals. They can be very small single-property transactions which allow folks to sell a rental property and use that tax deferral advantageously.

Deferral does not mean you are never going to pay it. It just means, I do not have to pay it right at this minute.

Senator ISAKSON. And with Ms. Cantwell here, present on the committee, Senator Cantwell, I want to make another point about labeling. She has worked steadfastly on low- and moderate-income housing tax credits, and you have in your testimony a reference to tax credits.

There are those who might consider tax credits as a benefit to the wealthy who are buying the tax credits to defer a tax or put it off down the line, but in fact, it is the best way we can raise money for housing for people at the low- and moderate-income level that will be needed after Harvey and Irma and other storms that we are going through right now.

So let us not be too quick, Republicans or Democrats, to label something as anti-progressive or as a tax break for the rich. When we look at the whole consequence and the collection of that tax, sometimes we are mislabeling things for the wrong reason.

Would you agree with that? And just say, "yes."

Ms. HARRISON. I absolutely do. Labels tend to be very dangerous. They lead us not to examine the actual facts underlying the statements we have made.

Senator ISAKSON. Thank you, Mr. Chairman.

Ms. HARRISON. Thank you.

The CHAIRMAN. We will now turn to Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman. I very much appreciate this hearing, and I appreciate the comments that both you and Senator Wyden made.

One of the reasons we talk about principles is that we want to make sure that when we do certain changes in the tax code, it does not have unintended consequences that are contrary to the purpose of what we are trying to do in tax reform.

So, Mr. Chairman, when you mention that middle-class families need help, I agree with you. And I think most of us agree, and we want to make sure at the end of the day that, when everything is said and done, we are not asking middle-income taxpayers to shoulder a greater burden of the cost of this country than they already are. In other words, we want to make sure the progressivity is maintained and that hopefully it is made more progressive as a result of our action.

When we look at other principles—and one I just really wanted to underscore is, many of you have been in the health-care debate, asking our States to do more. We talk about partnerships with our States. Well, let us respect federalism.

There is a reason why there is a State and local tax deduction beyond just the impact it has on who pays taxes. It is respect for the fact that it is the same taxpayers who pay State and local taxes who pay Federal taxes.

And there is something to be said about double taxation. The chairman was very active in trying to deal with corporate integration to deal with double taxation. Let us not create double taxation on those who are paying State and local taxes.

I just point out there are principles that become very important in our debate. And, Ms. Harrison, I am glad you are here, because home ownership is one of our principal objectives. And we should recognize that we want to make sure at the end of the day that we do not hamper the ability of individuals to own their homes. It has many positive aspects to it.

But what I want to ask a question on deals with fiscal responsibility, and it follows up a little on Senator Isakson's point. I think we all should agree that one of our principles is that we want to make sure that tax reform does not add to the debt, that it is at least fiscally neutral. And as I pointed out earlier, I hope that the Joint Tax Committee will be our arbiter as it relates to that.

But there are timing issues as to when you collect taxes, and Senator Isakson raised that issue. Senator Portman and I have worked a long time to try to improve retirement security in this country, because we recognize it is important. People are living longer. We believe in the three legs of the stool: Social Security, retirement, and personal savings. We need all three.

And if we do proposals that deal with timing in order to get revenues short-term, it could have an adverse impact on retirement security, but it certainly is not fiscally responsible. So, it is an issue that may have merits, but to use it for revenue, it has no merit.

So I wanted to ask, Ms. Batchelder, if you could just go over a little bit on the retirement security front as we look at tax reform, the impact it would have if we use timing issues for rate reductions, the impact it has on overall fiscal responsibility, and also what impact it could have on retirement security.

Ms. BATCHELDER. Thank you for the question.

I think this is a really important issue that needs to be discussed a great deal more. So the proposal that some people have advanced is to require people to make all or part of their contributions to their retirement plans on a Roth basis, which means that they are after-tax instead of pretax. And generally, right now people can choose between the two, whether to contribute on a traditional or Roth basis. And if their tax rates are constant over time—which is a big "if"—then those are actually identical economically. And it is hard for people to predict whether their tax rate is going to go up or go down.

So as a general matter, if a lot of people shifted to saving on a Roth basis, that should not have a large impact either way on revenues.

The problem is that it would have a very big timing impact. So it would mean that all of a sudden people who are taking deductions now when they make contributions to 401(k)s would not be taking those deductions and instead they would never be paying tax on the withdrawals.

And so you would end up raising a lot of revenue within the budget window and losing a tremendous amount of revenue outside of the budget window, which is why I think it is really critical that, whenever any tax reform bill or proposal is advanced, the committee obtain estimates from the Joint Committee on Taxation, both on the revenue impact within the budget window but also outside, because you can have very different effects in those two periods.

And as I mentioned in my testimony, I believe tax reform should raise revenue, but at a bare minimum be revenue-neutral. And it is really important that that is examined both within the budget window and on a long-term basis. As Mr. Brill's testimony referenced, those long-term budget impacts are really important.

Senator CARDIN. Thank you for that. Mr. Chairman, I just want to note that in regards to State and local, I had asked Secretary Mnuchin a long time ago for information as a follow-up to one of these hearings, and he has not responded. I would hope you would help me get that information from the Secretary.

The CHAIRMAN. I will be happy to try.

Senator Cassidy, you are next.

Senator CASSIDY. Thank you, Mr. Chairman.

Mr. Brill, Mr. Ponnuru references increasing the Child Tax Credit. Your testimony, though, contrasts two families, same income, but with different aged children. Implicitly, you are criticizing the Child Tax Credit deduction. So just elaborate on that. Again, I always like to take you all's testimony and see how it plays with each other. So go ahead.

Mr. BRILL. Thank you, Senator, for your question.

I would note in my testimony, as you described, and in some previous writings and articles that I have authored, that there is a wide disparity in tax liabilities currently, based on family size. That is by design in the tax code today, both as a result of the personal exemption and as a result of the Child Tax Credit, first at $500 in 1997 and then $1,000 starting in 2003.

This is part of this horizontal inequity that I described in my testimony. Ramesh makes an argument defending that disparity. I am simply pointing out that—in many regards—this question of fairness in the tax code relates not only to differences in tax liabilities about people who make more or less, but even within the same group——

Senator CASSIDY. But on the other hand, he is justifying that difference between those in the same group, saying that if you look at life-cycle expense of raising a child, that net, it comes out—now it is a bigger picture, if you will, if I may speak for him. He makes the problem bigger, and you make the problem more focused.

Again, do you, kind of, not accept the validity of his approach?

Mr. BRILL. I would not personally promote a larger Child Tax Credit in the context of fundamental tax reform, but I am very respectful of the arguments that he is making with respect to its impact on taxpayers and entitlement reform.

Senator CASSIDY. Secondly—again, I do not mean to pick on you. I just liked your testimony, so it triggered ideas. Ms. Batchelder cites a reference by you—I think it is reference number four—that you, with Joe Antos, put out something stating that our national taxes should be an increased amount of our GDP.

Now implicitly there, you are kind of rejecting the concept of dynamic scoring. Thoughts on that?

Mr. BRILL. Sure. Well first, with respect to dynamic scoring, certainly no, Senator. I do think that some tax policy changes can lead to dynamic effects and dynamic responses—not every tax policy change for sure—and that we should recognize that. That is one of the core reasons we are pursuing tax reform, I think: to promote economic growth. And to the extent that we are successful, we should capture those responses in our analyses. Sometimes those responses are overstated by some analysts, but I think they are real and that we should be able to rely on that information.

Second, with respect to the footnote, I did co-author a paper 4 or 5 years ago that was focused around a fiscal reform, around finding fiscal balance, bringing the debt-to-GDP ratio down in the long run. In that reform, there were a whole host of changes including a net increase in revenues over the long run.

Senator CASSIDY. Except that you just spoke about bringing down debt-to-GDP, and so therefore—just to, kind of, complete it, you would increase your tax revenue for the State going forward relative to GDP in the short-term, I gather, in order to decrease debt in the long-term. Is that, again, a fair statement?

Mr. BRILL. I cannot recall all the specifics. I believe that the revenue increases were phased in over time. This is a factor, that there are fundamental demographic shifts underway over the next few decades that will put increasing fiscal pressures on the government. We can reform those programs to save money, but we can also look at other ways to find balance——

Senator CASSIDY. So to put a point on that, and because I have been thinking about how we have a demographic bulge of the baby boomers going onto Medicare and Social Security, straining those programs. Medicare is going bankrupt in 17 years, and people are talking about Medicare for all.

So I gather then, from what you say, that in the short term you think that we may need—I am just quoting you; tell me if I am wrong. We need to increase the tax-to-GDP total amount in order to fully fund our Social Security and Medicare programs to take care of the bulge of the baby boomers?

Mr. BRILL. I am not actually advocating for a tax increase in the payroll tax to prefund future Social Security expenditures. I do think that given the increased demands on the system through the demographic changes, it is reasonable to think that, while those reforms to Medicare and Social Security are needed very much so, we cannot address those challenges only by changes in revenue. But I do think that if we can find efficient ways to raise revenue, that in the long run if there is more revenue into the system, if that revenue is collected in an efficient manner, that is a reasonable part of a comprehensive fiscal reform solution.

Senator CASSIDY. There are two components of that. If you grow the economy, people will pay more into the system only because they are making more money. The same percent results in more absolute dollars.

The second—your suggestion—is that you might sluice off dollars from another source that would feed into it over and above that which is coming from the payroll taxes.

Mr. BRILL. That is correct. I would be willing to consider both of those in the context of a comprehensive fiscal reform. It is different from the context of a fundamental tax reform before the committee today, but if we are thinking more broadly about the long-term fiscal challenges—this country faces many—we should be thinking about all our options.

Senator CASSIDY. I am over time. I yield back. Thank you.

The CHAIRMAN. Senator Brown?

Senator BROWN. Thank you, Mr. Chairman.

This spring, the guru of failed trickle-down economics, Martin Feldstein, let the cat out of the bag in a *Wall Street Journal* op-ed on April 26th, the day after Gary Cohn and Secretary Mnuchin released the one-page Trump tax plan. Professor Feldstein laid out in detail how Washington elites plan to pay for so-called tax reform with massive cuts to Medicare and by raising the retirement age for Social Security to 70.

The latest proposal now that they floated would take away freedom the American people have to choose a retirement savings plan that works best for them and force everyone into a Roth account, slapping taxes on retirement savings of working middle-class families. You have got to be kidding. I mean, the three best ideas to pay for massive tax cuts for Wall Street are to cut Medicare, raise the eligibility age to 70 for Social Security, and then steal from the retirement accounts of working middle-class Americans.

Tell the barber in Dayton, OH that he has to work until he is 70. Tell the construction worker in Warren, OH that she has to work until she is 70. Tell the waitress at a Columbus diner that she has to work until she is 70.

If the President and congressional Republicans want to work together with us, as Chairman Hatch promises us, to build a tax code that puts more money in the pockets of working Americans, that understands you grow the economy not by trickle-down, top-down tax cuts, but you grow the economy by investing in the middle class, we are there. Senator Wyden and I and all of us want to work—we want to reward employers that keep jobs in the United States. We are there to work together.

But if Senator McConnell decides to follow the same template he did on health care, where he brought in a handful of five or six—turns out to be all Senators who look like me, different party, but look like me—join with a few drug company, insurance company lobbyists, and then write the bill behind closed doors, he is going to have a hell of a fight on his hands, and we know that.

We know that this committee wants to work bipartisanly, the way we did on CHIP, the way we did last year, Senator Portman and I and others, on the Earned Income Tax Credit. But if they do not even show us a bill, as they did on health care, replace and repeal, or repeal and replace, or whatever they said—they do not want to show us a bill—if they are just going to try to jam us on a party-line vote for reconciliation, count us out.

I mean, I want to see a tax bill that focuses on the middle class to build the economy out that way. It is really pretty simple.

So my question, Professor Batchelder, is, what would be the impact of converting—their idea of raising the eligibility age of Social Security, cutting Medicare—what would be the impact of that, coupled with converting our current retirement savings vehicles from a tax-deferred model to a Roth model, on middle-class families trying to save for retirement? Talk through the impact of that, if you would.

Ms. BATCHELDER. Thank you for the question, Senator.

Well first, Medicare and Social Security—and I would add in Medicaid—are all programs that low- and middle-income families rely on tremendously in retirement and also, in the case of Medicaid, before retirement. So cutting those would put further strain on families who have spent their whole working lives counting on these benefits and have seen their incomes largely stagnate, especially compared to the most wealthy.

The Rothification idea, as we discussed a bit earlier—first of all, I am deeply concerned by the potential use of that proposal as a timing gimmick where it would raise, you know, potentially a trillion dollars within the budget window and lose more than that outside the budget window. And if one did not account for both those affects, one could use that trillion dollars within the budget window to pay for tax cuts for the wealthy and then end up losing even more outside of it, which would place even further pressure on programs like Social Security and Medicare in the long term.

The other point I did not have a chance to make is the Rothification idea would be really a dramatic change in retirement savings policy. Different families have different incentives whether they should select to save on a Roth basis or on a traditional basis. And for some it is advantageous to save on a Roth basis; for others it is not. And there are also very different rules about preretirement withdrawals. There are different effective contribution limits. So it is a real sea change in retirement savings policy that I think should only be done after very careful analysis of the impact on retirement savings on different families at different segments of the distribution, and not just because it happens to serve this budget gimmick.

Senator BROWN. Thank you. There is one more point I want to make about something slightly different, Mr. Chairman. One thing we did last year was put together—as we expanded EITC and CTC on a permanent basis, we put together a robust package of program integrity measures to make sure that we are doing everything possible to reduce the error rate for the tax credits on EITC, such an important anti-poverty measure, such an important incentive for work.

Now the House budget—and we were proud of that, that there is not really a lot of fraud in the EITC. There are a lot of mistakes in the EITC, where people were paid more or less because of errors in filling the forms out. That is the important point to understand.

Now the House budget has proposed that not one working family receive its Earned Income Tax Credit until the IRS has conducted a mini-audit of their finances.

What is that all about, Mr. Chairman? We need to go to work and make sure that our reforms on EITC stay in place and not the, sort of, mean-spirited attack on families making $20,000 and

$30,000 and $40,000 and $50,000 who depend on that $3,000 or $4,000 or $5,000 or Earned Income Tax Credit for the incentive, for the reward for their working hard and playing by the rules.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heller?

Senator HELLER. Mr. Chairman, thank you, and thank you to the ranking member. Thanks for holding this hearing.

I cannot imagine that there is a more important place to be today than to have this discussion in this hearing. So thank you so much, and I want to thank the witnesses also for taking time, for being here, the first hearing on tax reform.

I know everybody has the same goals; that is, to expand the economy, simplify the tax code, and to give the middle class some tax relief. So if you will indulge me for just a minute, I want to share my perspective from the State of Nevada, and that is that our middle class has suffered under an outdated and unfair tax code that discourages job creation and makes it harder for Nevadans, and frankly people all across America, to get ahead.

Just the other night, Mr. Chairman, I had a telephone town hall meeting, and I heard from a teacher in Las Vegas who spoke of stagnant wages. I also heard recently from a young Nevadan who started his own business while going to school full-time, and this 21-year-old brought up the enormous amount of money he is paying in taxes as well as how complicated it is to navigate our current system.

So Nevadans have been waiting for a fair, simpler tax code for way too long. According to a recent poll conducted by my office, more than half of Nevadans said it is important that Congress pass tax reform legislation by the end of this year.

And now we have a prime opportunity to do that and to provide relief to the American people who have been waiting for a fair and a simpler tax code. To me, relief means letting the middle class keep more of their hard-earned paychecks, making our tax code easier to understand—in essence, less paperwork, more money in their back pockets. It also means quality jobs, higher wages, and growth in our communities.

So the current economic situation is not acceptable. I look forward to working with all of my colleagues on both sides to address this issue.

Mr. Brill, if I could start with you. The average median household income in Nevada is about $55,000 according to the Census Bureau data. And, under various tax relief proposals, we have now seen a reduction. We have not only seen a reduction in the number of tax brackets from seven to three, but also a significant reduction in the income tax rates.

If we were to be successful here with this committee on tax relief and get it through Congress, how much money can the average hardworking Nevada family expect to keep?

Mr. BRILL. Thank you, Senator.

Perhaps that is the hardest question I have been asked so far.

Senator HELLER. I think it is *the* question.

Mr. BRILL. I appreciate the importance of understanding the tangible consequences of tax reform.

What I would note—there are three things that I think matter to median households.

One is the amount of tax that they are going to have to pay, just quite simply as you are suggesting, what their tax bill is. The larger that tax bill is, the less resources there are for other activities.

In addition, what their marginal tax rate is. And I know that a lot of people are not necessarily always aware explicitly of their effective marginal tax rates, numbers that economists like to discuss, but there is clear evidence that people are responsive to changes in these marginal rates. And higher rates are going to discourage work and discourage entrepreneurship and discourage investment.

And then finally, it is not only the taxes that are paid, but it is the cost associated with complying with those taxes. Many people who are earning $55,000 a year enjoy a relatively simple tax code today. They claim the standard deduction, but many do not and are faced with additional tax burdens, compliance burdens.

And in particular as it relates to the anecdote that you mentioned earlier, folks who are trying to start small businesses face additional compliance burdens much more so than ordinary wage earners, and that can be a hindrance in efforts to get those businesses going.

Senator HELLER. Mr. Brill, thank you.

Ms. Harrison, real quick. I am assuming—I am sorry I missed your testimony. I am assuming you are here representing the Realtors industry, and I want you to know that I appreciate all that your industry does, and I do consider it an economic indicator of how well an economy is doing. In no State was that more obvious than the State of Nevada during the recent recession.

And I missed your testimony. Will you tell me what your biggest concern is in this bill moving forward?

Ms. HARRISON. Well, I think I concluded with first, do no harm. When you are adjusting the moving pieces that this discussion is inevitably going to involve, we want to make sure that, just as you stated, the economic engine of home ownership and the transfer of real property in this country remains unfettered and is still allowed to continue in the way that it has, because, again, I am looking here at real estate household equity getting back to building wealth, $13.7 trillion. For many, many Americans, wealth building begins with the equity in their home.

They do not own stocks. They do not even think about that, but they do want to own a home. And to the extent that we have a stable economy, a growing economy, the equity in that home will grow with them as well and be available to them as they downsize their housing needs and their requirements change.

We want to make sure that that is preserved.

Senator HELLER. What is more important to you, growing an economy or your interest deduction?

Ms. HARRISON. I do not think that one exclusively is in the way of the other. I think done well, you can have both, because we know that, as I said, the transfer of real property is an economic driver.

When you have a depressed real estate market, you have a depressed country in terms of its economic——

Senator HELLER. And I said that in my opening comments. Yes, I agree with that.

Ms. HARRISON. Yes.

Senator HELLER. Mr. Chairman, thank you.

The CHAIRMAN. Thank you.

Senator Carper?

Senator CARPER. Thanks, Mr. Chairman. Thanks to you and our ranking member for holding this hearing. And I would just reiterate how important it is, I think, for us to return to regular order, to hold hearings, bipartisan hearings like this, where folks, stakeholders can come in from around the country and share with us their views. It is just incredibly important, and not only that we do it here, we do it again and again with other stakeholders at the table, and then we talk amongst ourselves as much as we did yesterday afternoon. So I applaud that, encourage that.

Lily, nice to have you back. It is great to see you, to welcome our other guests too.

My colleagues have heard me say this before, but I look at every proposal for tax reform through four questions. Is it fair? Does it foster economic growth? Does it simplify the tax code or make it more complex? How does it affect the deficit? Those are the four screens, if you will, through which I look.

Let me just ask each of you, "yes" or "no," do you think those are four good questions to ask? We will just start with you, Mr. Brill, just "yes" or "no"?

Mr. BRILL. Yes, I do.

Senator CARPER. Thank you.

Ms. Harrison?

Ms. HARRISON. Absolutely essential questions.

Senator CARPER. Ms. Batchelder?

Ms. BATCHELDER. Yes.

Senator CARPER. And Mr. Ponnuru?

Mr. PONNURU. Yes and yes.

Senator CARPER. Yes. Thank you so much.

In one of my other hearings—I have three committee hearings going on this morning. I want to be in all of them, but we have not figured out how to clone me yet. So I will bounce back and forth from one to the other.

But one of the hearings we are having is a follow-on to a GAO report. The idea in the Homeland Security Committee hearing that is going on right now is, how do we stop wasting money in a particular area? So that is the focus.

I remember having a hearing on the budget deficit years ago when I was a Congressman, and we talked about the need for revenues in order to, you know, we needed some extra revenues, we needed to do a better job on controlling spending. And one woman raised her hand at the back of the room, and she said, "I do not mind paying more taxes if it will erase the deficit. I just do not want you to waste my money." I just do not want you to waste my money—I have never forgotten that. So we are focusing on that in the Homeland Security Committee this morning.

One of the other things GAO does every other year is, they give us a high-risk list, high-risk ways of wasting money. And one of the things they have been dwelling on of late deals with the funding for the IRS. We have cut funding for the IRS by about 20 percent in the last 5, 6, 7 years.

And the current budget proposal from this administration calls for reducing the IRS budget by another 2 percent. Meanwhile, what we do in the Congress is, we change the tax code. We usually do it late in the calendar year. We do it in ways that make the tax code more complex, not less complex. We cut revenues to the IRS for people and for technology to provide customer service, and then we say, "Well why don't you fix this? Why do you guys not do a better job?" It is crazy.

For every dollar that we spend on funding the IRS, we are told we get back $4 to $10—for every dollar that we fund. Should we continue to cut, as has been proposed, continue to cut funding for the IRS in the next year? And we will start again with just "yes" or "no." Mr. Brill?

Mr. BRILL. I am sorry, but I am really not an expert on the budget side of the administration of the tax code.

Senator CARPER. Okay. Thank you.

Ms. Harrison?

Ms. HARRISON. I am certainly no expert, not in any way, shape, or form, but I would absolutely say wasting taxpayers' dollars is something no one looks forward to or wants or expects.

Senator CARPER. Ms. Batchelder?

Ms. BATCHELDER. I think we should be substantially increasing the IRS budget. As you said, if for $1 that is spent on the IRS budget for enforcement, the IRS collects—the last statistic I saw was $18 from people who are underpaying their legally owed taxes. Our tax gap right now is about $400 billion.

So a very easy way to collect more revenue from people who legally owe it and are evading it is to slightly increase the IRS budget.

Senator CARPER. Thank you.

Same question, Mr. Ponnuru. I am just looking for a simple "yes" or "no?" Should we continue to cut the budget for the IRS? We cut it by 20 percent. Should we continue to cut it, knowing that for every dollar we cut, we lose four or five bucks?

Mr. PONNURU. I am going to associate myself with Alex Brill's "no comment."

Senator CARPER. Okay. All right. That is an interesting response.

One of the things we try to do in a hearing like this is look for some consensus. It is a diverse panel—complex subjects, difficult subjects.

Give me one idea where you think you all agree on something, Mr. Brill.

Mr. BRILL. I think that—I certainly would associate my comments with Ms. Batchelder's comments about Rothification, both as it relates to timing and the potential significant impacts it has on retirement savings.

Senator CARPER. I succeeded Senator Roth in the Senate and on this committee, and he would be pleased to know his name is being used in this manner, I think, today.

Mr. BRILL. He would.

Senator CARPER. Please, Ms. Harrison, something where you think you all agree, and to the extent that you could agree on some things, it really helps us. Where do you agree on one issue?

Ms. HARRISON. We agree that tax code should be fair.

Senator CARPER. All right. Thanks.

Ms. Batchelder?

Ms. BATCHELDER. Well I would, of course, associate myself with Mr. Brill on Rothification, but I also agree with Mr. Ponnuru that we should be seriously considering expanding the Child Tax Credit, particularly for the lowest-income families. There is strong evidence about the impact on future child earnings, health, education, especially when there are young children, and especially when they are from particularly low-income families.

Senator CARPER. Thank you.

Mr. Ponnuru?

Mr. PONNURU. I agree with the comments about Rothification, and I also think, as Ms. Batchelder pointed out in her testimony, that eliminating the dependent exemption and increasing the standard deduction would be a bad tradeoff for a lot of middle-class families.

Senator CARPER. All right. Thanks.

Thank you all, and we will look forward to following up with some of you later on. Thanks.

Thanks, Mr. Chairman.

The CHAIRMAN. Senator McCaskill?

Senator MCCASKILL. Thank you, Mr. Chairman. I think one of the things that we all talk about is the complexity. And I am worried that the way this train is moving, we are going to get off on the track of rates and remove ourselves from the difficult job on complexity.

This is going to be a priority, as far as I am concerned, in terms of how we write this bill. A tax rate can be based on whether it is regular wage income, ordinary dividends, qualified dividends, long-term capital gains, short-term capital gains.

A deduction credit for higher education is different depending on whether it applies to continuing education, higher education, a family member's education, or several other subcategories.

We cannot even manage to define the word "child" consistently across the code. To me, we have two issues here. One is a disagreement over rates, both corporate and business organization around those rates, and a conversation about individual rates, and I do not hear enough heat around the complexity part.

Do you believe that clearing up some of the complexity could be as important to economic growth and prosperity in this country as some of the other things that are consuming all the oxygen in the room?

We will start with the guys who do not want to comment on how dumb it is that the IRS—there is nothing like being in debt and cutting your receivables department. Go ahead.

Mr. BRILL. I do agree that the complexity of the tax code is a cost separate and apart from the revenues that are imposed on taxpayers.

The number of itemizers in the system today, those taxpayers, 40-plus million taxpayers who itemize their returns, face additional burdens as a result of that. Now, they may get tax breaks as a result of that, but the compliance costs with itemizing are significant. In addition, over 40 million taxpayers claim a credit, which is additional paperwork as well.

Again, they are receiving tax reductions as a result of the policies, but they are also burdened with costs. This disparity creates similar taxpayers with different tax burdens, sometimes very similar taxpayers with different burdens.

If your child is 17 or 16, your tax liabilities will be different. If you rent or if you own a home, of course, your tax liabilities will be different. So this creates some degree of complexity and uncertainties that are significant, and I think that it is reasonable and appropriate to address those complexities in the process of pursuing tax reform.

Senator MCCASKILL. If we do not do it now, I do not think it will get done. I think we will still have 70,000 pages.

I want to challenge a little bit our Realtor. I certainly understand that the mortgage interest deduction is a behavior-modifying provision as it relates to people when they buy their first home. No question. I did the math. This is what I am paying for the apartment, this is what it will cost me in a mortgage where I get to deduct the interest; therefore, I was ready to buy my first home. I do not remember doing that analysis when I bought a still very modest second home.

Do you have any studies that show that the buying of homes, the second or third or fourth home that the family buys, that somehow they are considering going back to an apartment if they do not get a mortgage interest deduction?

I mean, the idea behind the mortgage interest deduction was to modify behavior and encourage home ownership.

Are there any studies that show that you would lose people to rental properties if this deduction was removed for people who were moving on to bigger and bigger homes in their lives?

Ms. HARRISON. The short answer is, I do not think so. But again, the deduction for mortgage interest, this has been embedded in the tax code since 1913, I think. So it is not something that we just kind of put in place to encourage first-time homebuyers, but it certainly is in place to encourage home ownership itself.

As regards recurring transactions, we real estate professionals and Realtors, certainly that is how we make money, and it is also the story of our lives, if you will, because we begin with the first home, perhaps a condo, as a single person and maybe we get a partner.

So as our circumstances change, our housing needs change, and that often is the trigger for the purchase or the sale of the first home, the purchase of the second home.

So it is a life story that is going on here. What we have here with the mortgage interest deduction is that statement by the Federal Government that we believe in home ownership and the benefits that go beyond simply that tax benefit, but the benefit that that gives to society when we are indeed a Nation of homeowners rather than a Nation of renters.

Senator MCCASKILL. I understand the point you are making, but if we look at what we do with the tax code, the tax code provisions ostensibly are in place to encourage certain behavior and/or economic growth.

I just think it is important as we try to analyze the tax code and figure out a way to bring down some rates and make it fairer that we look at every single one to see if it is accomplishing what it is supposed to be accomplishing; if it is not, we should reconsider it.

That is why I wanted to see if there were any studies that showed it did modify behavior for future home purchases beyond the first home.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Casey?

Senator CASEY. Mr. Chairman, thanks very much. We appreciate you and the ranking member having this hearing and a number of hearings on the broad issue of tax reform. So I commend you for that.

I know there is a substantial disagreement about the insistence on our side to have three basic guiding principles. I do not understand the opposition to those, but I just want to state them again for the record. Number one, regular order—that should be easy. I think both sides agree on that one. So far we are batting 300.

The second one, of course, is making sure that we do not increase the deficit by way of tax reform. I think we can agree on that, I hope.

The third one seems to be the most difficult, and I have a very strong view of this. You, Mr. Chairman, I am sure, disagree. But why is it that we cannot agree that the top 1 percent should not benefit from this process? The top 1 percent of the last generation has had a bonanza. They have been doing pretty well.

Anyway, I just wanted to restate those, because I know we have to be honest about the differences even as we commend the work of the chairman trying to keep people together in terms of hearings.

The CHAIRMAN. I do not think there are any differences with regard to the top 1 percent.

Senator CASEY. I hope not, and I appreciate it.

The CHAIRMAN. Certainly not that I know of.

Senator CASEY. I want to focus on something that we do not talk about enough, frankly, and I think tax reform gives us another chance to not only talk about it, but to actually do something about it.

On both ends of the aid scale among young people, whether it is young children on one end or college students on the other, we have all seen the horrors of higher education costs going up. Senator Toomey and I represent a State where we have a great system of higher education and great institutions whose tuition has gone way up with regards to public 4-year colleges.

But here is the reality on the other end of the scale. As much as we are concerned about higher education costs, in fact, in 33 States and the District of Columbia, here is what we are facing: infant care costs exceed the average cost of in-State college tuition at public 4-year institutions. I will say it again: infant care costs.

Senator Murray and I and a number of Democrats have a bill to focus on that. And you all know the numbers. I was not here for

Ms. Batchelder's testimony, but you know the costs. Sometimes families can be paying as much as a fifth of their income on child care. So we wanted to focus on that in our legislation.

Here is the question for Ms. Batchelder. Can you discuss what the President's past proposals on child care have looked like and why a credit for child care costs is preferable to a deduction? If you can, walk through that again.

Ms. BATCHELDER. Thank you for the question.

The President last fall came out with some proposals regarding child care, and I do applaud him for focusing on the issue. The problem once again was that his proposals did not actually address the challenge.

They provided larger benefits to higher-income families and very small benefits to lower-income families, even though lower-income families tend to spend a much larger share of their budget on child care costs. And as you just explained, particularly for infants and young children, those costs can be astronomical.

So his plan was both not targeted on the people who need help the most, it was also very complex, going to Senator McCaskill's point.

Right now we have two tax benefits for child care, which is already less than ideal, and it would expand that to five. There is evidence that once you give people lots of different tax benefits that they have to choose between, they often do not choose the best one for themselves. So that complexity hurts the taxpayer.

I think a much better approach—and I really applaud you for working on this issue—is to have a refundable tax credit for child care that is targeted on people whose costs impose the biggest budgetary strain for them. That would require that the tax credit be refundable.

Right now about 35 percent of households are in the zero bracket, meaning that their income is less than the standard deduction and personal exemptions. So that means they do not owe Federal income tax, even though they pay vast amounts of Federal payroll tax and other State and local taxes. So if you give them anything other than a refundable credit, it is worthless to them. The refundable credit is very important.

The one other thing I would mention which is not strictly individual tax reform is, it would be very helpful to fully fund the direct spending programs for child care. Right now only 15 percent of people eligible are able to actually claims those subsidies. And particularly for lower-income families, the direct spending program may be more efficient even than a tax credit, because they are paid out as your child care bills are due rather than at the very end of the year.

Senator CASEY. Great. Thanks very much. Thanks, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman and Ranking Member, for a very important hearing. And thank you to all of you for being here.

Ms. Harrison, I just want to indicate I am with you on the mortgage interest deduction. So we certainly want to see, in my judgment—I am certainly supportive of making sure we have that for middle-class families.

I also want to underscore what Senator Casey said in terms of where we start. When I look at this through the lens of Michigan, which, of course, I do, Michigan families, working families, small businesses and so on, I start from a very basic premise of saying we do not want to explode the deficit on whatever we do, we want it to be bipartisan, and we do not want the benefits going to the top 1 percent in our country who have received a majority of benefits of recovery and of other past proposals.

I am hopeful that we are going to reject clearly the House Blueprint, which would give over 99 percent of the benefits to the wealthiest Americans. And by the way, in looking at how Michigan ranks, Mr. Chairman, we are at the bottom, totally at the bottom on that one. So as far as I am concerned, throw that one out.

President Trump's plan at this point gives the top 1 percent a tax cut, each person, of over $270,000 a year. So that does not work for me, for Michigan middle-class families either, and it would increase the deficit by $3.5 trillion.

So I am hopeful what we are going to do is work together on a bipartisan basis to actually focus this on middle-class families, on small businesses where, frankly, the majority of jobs are being created, and that we are going to learn from what happened in the past, what did not work and what did work, and that we will build on what has grown the economy and jobs in the past.

I wanted to ask, Ms. Batchelder, when we look at tax reform, what lessons can we take from other efforts, early 2000s with the Bush tax cuts and before that with President Bill Clinton and those efforts as well? When we look at differences in approaches, what can we learn in terms of making sure that the benefits of tax reform go to working families and small businesses?

Ms. BATCHELDER. Thank you for the question, Senator.

I guess one thing that I would say one could learn, if you go back especially to the 1986 act, is the importance of working on a bipartisan basis. Tax reform is more likely to endure if it is passed on a bipartisan basis and done in a very transparent way.

Back when I was working for the committee, I spent a lot of time working on tax reform. We put out lots of option papers. We put out discussion drafts. Tax reform is really complicated and there can be lots of pitfalls if you do not put out legislative language well in advance and let the public comment on it, point out problems with it, point out unintentional loopholes.

So I think the first thing would be to have a bipartisan and transparent process.

The second would be to look very carefully at the revenue and distributional effects. Thankfully, with the advent of computing and all sorts of things, we have a much better sense of that than we did back in 1986. The Joint Committee on Taxation does excellent work on estimating the effects of tax bills, but I think it is really important, before any votes are taken, to know the budget consequences, both within and outside the budget window, and to know the distributional consequences within and possibly outside the budget window.

Really, the way you can tell whether the middle class is benefitting is when you look at those tables that they do that say what is their percentage change in after-tax income.

Senator STABENOW. I agree with that. Also, I agree with the openness and transparency and bipartisanship of the 1986 reforms.

One of the successes was that it helped to ensure that the wealthiest were paying their fair share and gave a tax break to middle-class folks and folks working hard to get into the middle class.

I am hopeful that that will be the path and that we will focus on those things and not trickle-down economics that just has not worked, has not put money in the pockets of the majority of people in Michigan, that is for sure.

One other quick thing, and that is tax reform as it relates to closing loopholes. I am concerned about not creating new ones that individuals can abuse.

I know my time is about out. So I will just ask, Ms. Batchelder, how can we help ensure that we are closing loopholes rather than seeing new ones?

Ms. BATCHELDER. The most important thing I would flag in the brief time I have is the proposal to create a rate cap on pass-through business income, which would be a giant new loophole in the tax code and would really go in the opposite direction of what I would hope happens in tax reform.

The estimates are that it would cost a huge amount, about $2 trillion, and 30 percent to 50 percent of that would be people avoiding taxes, because it would create huge incentives for people to characterize their labor income as pass-through business income. And really it would be the sophisticated taxpayers who can access fancy tax advice that would figure out how to do that.

Furthermore, it would not benefit at all anybody who was in the 25-percent bracket or below or the 15-percent bracket and below under the President's plan and the House Republican Blueprint, in that 95 percent of taxpayers are in the 25-percent bracket or below.

So it would not benefit small businesses. It would really benefit the wealthy who are able to game the system.

Senator STABENOW. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Toomey?

Senator TOOMEY. Thanks, Mr. Chairman.

I just want to touch on an area that I think we have established there is universal agreement on and then make a point where I think, evidently, there is a lot of disagreement.

I think we have all agreed that we would like for tax reform to provide tax relief for working-class and middle-income families, and I certainly agree with that.

I do not agree that we have to systematically exclude the people who are very productive, successful, and pay a disproportionate amount of the taxes in this country.

I will just give a couple of statistics that it is politically incorrect to mention, but I will mention them anyway. The fact is, the top 10 percent of income earners earn 47 percent of the income in America and pay 71 percent of all the taxes. The top 1 percent make about 20 percent of the income and pay 40 percent of all the income taxes that are paid.

In my view, we ought to have a very pro-growth tax code that is going to encourage an economic expansion, and if, along the way, a relatively wealthy person manages to benefit from that, I, for one, am not going to lose any sleep at all.

We have an extremely progressive tax code, and it is going to remain a very progressive tax code. I hope we focus on creating more wealth for everybody rather than who must we insist on not being able to benefit from this.

I want to ask Mr. Brill a question about itemized deductions. If I understand your testimony, you have made a point that itemized deductions generally, and the State and local tax deductions in particular, have some perhaps unintended features.

They tend to be regressive in the sense that they disproportionately benefit higher-income people; is that true?

Mr. BRILL. Correct, yes.

Senator TOOMEY. Would it be fair to characterize your view on these deductions as an indirect way in which States with higher State and local taxes are subsidized by States with lower State and local taxes indirectly through the Federal tax code. Is that true?

Mr. BRILL. That is true. It is certainly a subsidy to the States that utilize those provisions.

Senator TOOMEY. And the effect of this, of course, all else being equal, is it keeps Federal marginal rates higher than they would otherwise be if we had a different treatment, a lesser treatment on State and local tax deductibility. We would be able, if we chose to, to use that to lower marginal rates.

Mr. BRILL. Statutory rates could certainly be reduced if the base was broadened.

Senator TOOMEY. Let us talk a little bit about the different ways that we could go about lowering the tax burden. I was interested in Mr. Ponnuru's testimony, and he makes a persuasive case on a number of grounds for a Child Tax Credit, and I am sympathetic to many of his arguments.

To his credit, I think, he did not argue that a consequence of increasing the Child Tax Credit is an immediate expansion or acceleration of economic growth. However, if you lower marginal rates, you change incentives. You increase the incentives to work, to save, to invest.

Is it your view that lowering marginal rates does have a nearly immediate positive effect on changing incentives and, therefore, encouraging economic growth?

Mr. BRILL. I have a somewhat nuanced view, Senator. Lowering effective tax rates, yes, will increase the incentives to work and can increase the incentives to save and invest, for sure.

It becomes a little bit trickier, just to be honest, when you are simultaneously broadening the base and lowering the statutory rates, how that affects these true effective marginal tax rates.

My colleague, Alan Viard, and I wrote about this a few years ago, that base broadening can sometimes neutralize some of the positive effects of lower rates. That is not to say that we should not do that. We can get efficiency gains that are very important and powerful.

Senator TOOMEY. Would it be fair to say that some base broadening could have a tendency to diminish economic growth, while other base broadening would actually encourage it by eliminating distortions?

Mr. BRILL. Correct.

Senator TOOMEY. In the absence of base broadening—just putting that aside for a moment, since that can have either effect—lowering marginal rates by itself does tend to accelerate economic growth by enhancing the incentive to produce more goods and services.

Mr. BRILL. Correct.

Senator TOOMEY. So as we weigh the various alternatives available to us, one of the ways that we can be very confident we would be encouraging a pickup in economic activity and, by the way, all the related benefits, right—a higher standard of living, higher wages working their way through the economy—we can be very confident that lowering marginal rates has that effect.

Mr. BRILL. In isolation, lowering marginal rates will encourage work, entrepreneurship, savings, and investments, for sure.

Senator TOOMEY. Thank you. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. Thank you and the ranking member for holding this important hearing.

So many of your comments and, obviously, the comments of many colleagues—there are lots of interesting things floating around here today.

There is one thing I wanted to make sure that I was clear on in the President's proposal about getting rid of State and local tax deductions. We have fought for nearly 10 years and finally got restored our ability to deduct our sales tax from our Federal obligation, because we do not have an income tax.

So I hope the Senators from Florida and Nevada and Texas will join me in saying that this idea of trying to get rid of our State flexibility is dead, dead on arrival. I hope those Senators from Florida and Nevada and Texas will help us say that—obviously, our colleagues from other States too, but I am talking about people who are members of this committee. That would be so helpful.

Now, the ranking member and I come from a part of the country that has probably two of the most unique tax codes in the country, very different ways of raising revenue, and yet our economies have grown faster than the national average, I think every year since World War II.

So the notion that Oregon and Washington have very different tax codes than the rest of the Nation, we are more efficient in a lot of ways, and we deliver better growth is something that people should look at.

So the notion that somebody wants to knock out, that the President's proposal is primarily trying to get $1 trillion out of getting rid of local deductions, I just think is wrongheaded, and I hope our colleagues will join me in saying so.

Secondly, we sent a letter to Democrats from this committee and others about how we wanted to focus on better wages for the middle class. I guess, Ms. Batchelder, I have question for you on that.

I do want to point out and enter into the record, Mr. Chairman, this article from *The New York Times* by Patricia Cohen and Nelson Schwartz that basically economists see very little magic in tax cuts to promote growth.

[The article appears in the appendix on p. 80.]

Senator CANTWELL. Their point is, do not deficit-finance tax cuts because you are not going to see the growth from that, which is also the second point of our letter, which is, let us not have issues of deficit just to give corporate rate cuts.

Now, from the State of Washington, I guarantee you I care about corporate competitiveness from the perspective of an Amazon, a Microsoft, a Boeing, an agricultural economy where 90 percent of our products are shipped overseas. I guarantee you I care about that competitiveness. But I care in a transformative economy where more change is happening, more dislocation is happening, more skills need to be upgraded constantly. I care about what we are going to do to raise the wages of the middle class and grow the economy from the middle out.

Ms. Batchelder, I do not know if you can tell me, but one of the things we are very interested in is making sure, because corporations are investing one-half of what they did 20 years ago in worker training, if you think that incentives to help us retrain and reskill workers should be a priority?

Second, so many people have fallen off of the housing affordability wrung. So the consequence is they have fewer—we have a burgeoning level of unaffordability in America. So if we want these people to be reskilled and retrained, we have to have a house over their head.

So how much do we need to focus, if we want to grow the economy from the middle out, on the kind of investment structures that we need to put in for middle-class wages to increase?

Ms. BATCHELDER. Thank you for that question. I think one of the most important things that one can do to boost middle-class wages and for lower-income families, as well, is expand the Earned Income Tax Credit and the Child Tax Credit.

Those are both programs that have demonstrated effects not just immediately on the incomes of such families, but also on their kids for generations to come. There are strong outcomes in terms of education, health, long-term earning.

There have been proposals to significantly expand the Earned Income Tax Credit also for childless adults, as they are so called, people who do not have dependents, who often have relatively low labor force participation rates. And by expanding that credit, you could encourage people to enter the labor force or be able to work more.

This is actually a group—it is the only group that is currently taxed into poverty. And you could also more ambitiously consider expanding the EITC for families with children as well, and that would be a way to offset the fact that the take-home pay of middle-class families and lower-income families has been growing much, much slower than the top 1 percent.

Senator CANTWELL. What about job training and housing?

Ms. BATCHELDER. Job training, I think, could be worth considering as part of education benefits as a whole. In general, I tend to think that delivering tax benefits directly to the people you want to benefit, *i.e.,* the middle-class family, more of that will accrue to them than if you do it indirectly.

But I think that that is—education, including job training and including certificate programs, is something that one could look at as part of reforming education tax benefits.

Senator CANTWELL. What about the unaffordability issue that we are facing in America?

Ms. BATCHELDER. On housing?

Senator CANTWELL. Yes. About increasing the Low-Income Housing Tax Credit——

Ms. BATCHELDER. Absolutely, I think that is worth considering.

Senator CANTWELL. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bennet?

Senator BENNET. Thank you, Mr. Chairman. I am very grateful for your holding this hearing and the manner in which it has been held.

Mr. Ponnuru, thank you for your work. The United States is unusual among advanced economies in that we have millions of children living in poverty in our country, some in families that make only $2 a day in cash.

I wonder, in that context, what your view might be of phasing the Child Tax Credit at a faster rate and from the first dollar rather than where we do it today.

Mr. PONNURU. I support that idea. As I note in my testimony, the existing Child Tax Credit already lifts around 3 million people out of poverty, and an expanded Child Tax Credit would have even more of such an effect, particularly if the Child Tax Credit were made refundable against payroll taxes as well as income taxes, and I would say both employer-side and employee-side payroll taxes.

Such estimates as have been made of similar proposals suggest that it would be a significant increase in after-tax income for the bottom quintile of income earners and, for that matter, for the second-lowest quintile.

Senator BENNET. Let me ask you what your thoughts would be about a universal Child Tax Credit of some sort that might provide a monthly benefit to families in our country.

Part of the problem here we are trying to figure out is how you deal with the fact that what you want people to be able to do is work—everybody wants people to work—but when people are living in poverty, it makes it that much harder.

Things like the cost of housing, as Ms. Batchelder mentioned, the cost of transportation, the cost of child care, the cost of health care, all of these things, when you have a diminished income, are making it harder and harder for people to get into the position we want them to be, which is contributing to the economy.

I take it—and then I will stop—that the reason why you support some of these ideas is that they are an efficient way to distribute these benefits rather than building more bureaucracies that might not get the eighth of the people that you are trying to get it to. Your thoughts on that.

Mr. PONNURU. I am sorry. Were you asking me about a universal basic income or a universal child allowance?

Senator BENNET. A child allowance.

Mr. PONNURU. Great. Thanks. I think that the expanded Child Tax Credit is maybe a slightly more moderate version of the same idea, but it does have the advantages that you are talking about.

So many of the concerns that Senators have raised during this hearing, from the affordability of housing to the affordability of child care, the affordability of higher education, these are things that families could use an expanded Child Tax Credit to help finance, among many other reasons they could use that money.

They could use that money to finance paid leave from employment when a child is very young. But families have very different needs, and I think it is a good idea to create this flexibility where it is up to them to make the decisions as to how to allocate that additional money.

Senator BENNET. Is there anybody else who would like to comment on this?

Ms. BATCHELDER. Yes. If I could just chime in on the Child Tax Credit. I do think it is very important to consider increasing the refundability rates. Currently, one has to earn $3,000 in order to get any Child Tax Credit, and then you sort of get $0.15 on the dollar above that.

Senator BENNET. Right.

Ms. BATCHELDER. The result is that about 11 million children are excluded who live in households with working parents, and millions more whose parents in the current year are not working.

So I applaud your proposal to expand that refundability and reduce that threshold. There have been discussions of making the Child Tax Credit refundable against payroll tax, and one concern I have is that that would not actually benefit low-income families much at all, because payroll tax is 15.3 percent and the current rate is 15 percent. So you would just be giving a 0.3-percent bump.

I think it is important to really increase that rate at which low-income families can earn the Child Tax Credit beyond making it refundable against payroll taxes.

Mr. BRILL. I would just note one unintended consequence in making changes to this policy. If the Child Tax Credit is limited, it phases out as an income exceeds a certain threshold, I think $110,000 for married couples.

If the Child Tax Credit were to get larger, that phase-out, which is an implicit tax, would affect more and more taxpayers. It would be another matter that the committee would need to wrestle with.

Senator BENNET. Thank you. I appreciate the testimony, Mr. Chairman. I am sure other people's States are like mine. Even in our State, where we see an economy that is really second-to-none in the country, middle-class families and families living in poverty are struggling with the costs of higher education, as you pointed out, the costs of early childhood education—which in our State actually costs more, on average, than higher ed—housing, and health care.

Those four things are conspiring to make it impossible for people to save or feel like they are putting their family in a better position for the future. That is why I hope we can get to bipartisan tax reform.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Portman?

Senator PORTMAN. Thank you, Mr. Chairman. I want to thank you and Senator Wyden for holding the hearing and for some great testimony today from our former colleagues.

Alex was on the Ways and Means Committee with me, Lily here on this committee, and we need your expertise. So thank you.

I guess following on to what Senator Bennet said, I think that is what is so exciting about tax reform, and I think it goes to, in my view, more the economic growth and the wage improvement that is going to come from good tax reform, and it is across the board.

If you look at Kevin Hassett's work—he is now the new Chairman of the Council of Economic Advisers as of a couple of days ago—and other studies that have been done, including by AEI, corporate rates, if they are lowered and we have a more competitive international system, will result primarily in wage growth, wage and benefits.

CBO has a famous study on this from a while ago showing it is 70 percent. Others have different numbers. But the point is, that is about wages.

On the individual side, I think the same is true. If you do, in fact, broaden the base, get rid of some of the complexity of the code, and lower rates, I think it will have the same benefit.

So to the extent we are concerned about what Senator Bennet said, which I agree on, which is kind of the middle-class squeeze, higher expenses on everything, especially health care for most middle-class families, and then flat wages, which is generally true over the last couple of decades, this is, I think, the single best thing to do.

In 2006, there was a study done by the Joint Committee that found that a proposal that would expand the tax base while lowering individual rates across the board by about 25 percent would increase GDP up to 3.5 percent in the long run. That increase in the second half of the budget window is about a $2,500 to $5,000 increase in income for a family of four. That is on the individual side.

So I think both on the individual side and the business side, we have a great opportunity here.

I would just ask, Alex, because you talked about this some in your testimony, in recent tax reform efforts, base broadening and rate reduction have been coupled with, in general, this doubling of the standard deduction. We talked a lot about that today.

You talked about who benefits from itemizing and who does not. But do you see any benefit in reducing the number of taxpayers who have to itemize, just from a compliance point of view, as well?

Mr. BRILL. I do, Senator. Thank you for your question. There are a number of benefits from reducing the number of itemizers, including, in particular, the compliance costs associated with itemizing, as well as this horizontal equity issue that I described in my testimony, that taxpayers earning similar incomes should ideally, I think, pay roughly similar amounts of taxes.

Senator PORTMAN. Two hundred and seventy three dollars is the estimate that we have for people who itemize, who have to have someone else prepare their tax return. So that is saving some money right there just in compliance costs.

On Rothification, we talked about that earlier—Senator Cardin talked about it, Senator Isakson; Lily, you answered it; Alex, you answered it.

I think what we are missing, though, in terms of the back-and-forth here is the effect on behavior. I understand the timing issue. That has always frustrated me, and Ben Cardin and I have struggled with this over the years. How do you help to expand 401(k)s and IRAs and not pay the penalty for it? Ultimately, that tax is paid—it is deferred—but not within the 10-year window.

But with regard to Rothification, I just wanted to ask you—and certainly you can tell I am concerned—do you think that would create a disincentive to save? Because part of the issue that I look at is, you do have the choice now of Rothification and that is good, I am glad we have that choice, which means that you do not get the tax benefit up front. You do not get a deduction, and you take a risk what the tax rate will be later when you have to pay it, whereas with the traditional IRA or 401(k), you get a tax deduction.

I talked with some businesses this week that said the take-up on the Roth is very low. We are talking less than 5 percent of people taking it up.

So if we go to Rothification in order to make our numbers look better, what is going to be the incentive to save? We have a serious issue in our country right now of people not saving enough. As the baby boomers begin to retire and are living longer, would we not want to encourage savings, and are you concerned about Rothification in that context?

Mr. BRILL. I am. As Lily described earlier in her testimony, there are circumstances where, in theory, it is a wash. There are circumstances where it is not a wash, depending on what your current tax rate is versus your future tax rate.

So you can write down—an accountant can write down why these are either two neutral or equivalent policies, but what matters is the real-world evidence. As you suggested, the take-up rates for Roths are significantly lower, and I think there is a fair amount of uncertainty about how a change—instead of the choice that we have today, if that policy was mandated, in some sense, as your savings operative vehicle—how that might affect investment.

I, frankly, do not know what the effect is, and I think that policymakers should be cautious.

Senator PORTMAN. I think there are some studies being done right now.

Lily, do you have a comment on that?

Ms. BATCHELDER. I think as a matter of theory, one could argue it either way. It is possible it could increase savings. There are also strong arguments, and I think you are raising one, that it could decrease savings.

But I think this gets to the broader point that, if one were to have such a dramatic change in retirement savings policy, you would want to have a group like the Joint Committee on Taxation estimate what the effects would be on take-up and savings.

I think it also goes to the broader point that the single biggest thing that influences people's likelihood to save is whether they have access to an easy way to save through their employer.

Personally, I would prioritize something like an auto-IRA over this as a way to give people access to an easy way to save at work.

Senator PORTMAN. Thank you all. Thank you, Ramesh and Ms. Harrington, for your testimony as well.

The CHAIRMAN. Thank you, Senator.

Let me just end this. I would like to ask a question of Professor Batchelder. You express concerns about the potential repeal of the, quote, "head of household" filing status as part of tax reform.

I think you have raised some valid points. That said, I have some concerns that the current "head of household" status may be causing significant taxpayer confusion and is potentially prone to abuse.

An audit conducted by the IRS's National Research Program for the 2009 to 2012 tax years indicates that 45 percent of the individual tax returns claiming the "head of household" status erroneously claimed such status. That is, 45 percent of returns filing as "head of household" were not entitled to the tax benefit it affords.

Now, that is an alarmingly high error rate. Do you have any suggestions on how this error could be addressed, and would it be possible to make up for a lack of "head of household" status in other ways, such as through an increased Child Tax Credit, for instance?

Ms. BATCHELDER. I am not familiar with that study. I find it very surprising. So I would like to look at it and would be happy to comment for the record on it. I think it is hard to replicate the benefits of the "head of household" filing status in general, because it is specifically for people who are unmarried and who may be divorced, may have never married, and have dependents.

So if you just increase, for example, the Child Tax Credit, you would not be getting at the issue that sometimes there are greater costs and difficulties associated with raising a child on one's own rather than with one's partner.

But again, I am not familiar with that study. So I would like to look at it before commenting.

The CHAIRMAN. Thank you. Senator?

Senator WYDEN. Thank you very much, Mr. Chairman.

I just want to give a quick summation of where I think we are and what's coming in the days ahead. First, Mr. Chairman, I think you know how strongly I feel about working closely with you. We have done that consistently and done it most recently on CHIP. So I look forward to working with you.

Second, we have had a lot of constructive discussion here today; obviously, some differences of opinion, but constructive discussion. And I surely hope that they are listening to this discussion up at the White House, because right now one of the critical challenges is, up at the White House, there has been a big gap between words and deeds.

Just yesterday the President said, "Look, I am not going to give big tax breaks to the wealthy." But as I have pointed out today, Ms. Batchelder has pointed out today, the outline as of today creates a new enormous loophole for the fortunate few with respect to the pass-through issue, a real abuse of the pass-through issue, which is supposed to benefit small businesses.

We have gone through today, also, how as of now working families would be hurt. They have been saying they would correct that for months and months. I have asked them about it, Mr. Mnuchin at these hearings—still not corrected. Big gap between words and deeds.

Now, Democrats have laid out principles that I think are very important. We have called for fiscal responsibility and a process that is fair to all members, where they can offer their ideas. It would be progressive, and we would not be sending more relief to the 1 percent.

I want to, again, say this does not go as far as what the late President Reagan did when he treated income from wages and wealth the same in 1986.

Now obviously, times change, and 1986 and 2017 are very different kinds of times. But traditional principles of fairness and bipartisanship really do not change. Those are principles for the ages. And this matter of being bipartisan is especially important, and I think a couple of you may have touched on it—I think we had Ms. Batchelder, several of you. So it spans the ideological spectrum.

The reason you are bipartisan is really twofold. You need both sides to stand together in terms of fighting off special interests and making sure that both sides are committed to getting rid of some of the junk that has gotten into the tax code. An awful lot has, in almost 32 years.

In fact, in 1986, they were working on a tax climate that was really 32 years before that. So it is almost like 32 years is a magical number with respect to tax reform.

If it is not bipartisan, you will not have the certainty and predictability that the country needs, because people will just say, "Hey, it was partisan. We will go back and just change it when we take power."

So, Mr. Chairman, I surely share that view.

I have written what are really the only two comprehensive, bipartisan tax reform bills since that original one, most recently with a member of the President's cabinet. Nothing would be more satisfying and enjoyable, enjoyable professionally, Mr. Chairman, than to work with you and all of our colleagues, as we have said, toward building an updated tax system that works for the days ahead rather than being a relic of yesteryear.

We have laid out principles that we think help to do that in a bipartisan way. Thank you for this hearing, and we will look forward to working with you in the days ahead.

The CHAIRMAN. Thank you, Senator.

Let me just say this. Ms. Batchelder, you had proposed that the tax code be made more progressive than it currently is. The question that naturally arises for me is, at what point would it be too progressive?

Once that point is crossed, what harms might come from that? If we could just tax Bill Gates and all the rest of us have nothing, then why not?

Do you care to take a crack at that?

Ms. BATCHELDER. Well, I certainly think there is a point where the tax code could either be too progressive or too targeted on just one or a handful of individuals, but I think that we are very far from that point.

We have very vastly rising inequality in this country, and the tax code could do a lot more to help mitigate that. So I do not think anything that is on the potential drawing room table right now is at risk of making the tax code too progressive.

I am sure if you proposed replacing the entire income tax system with only taxing Bill Gates, I would think that was both unfair and inefficient.

The CHAIRMAN. Mr. Brill, I would like you to weigh in on that question, too, if you would.

Mr. BRILL. Thank you, Senator. My personal view is, I think it is appropriate and good that the tax system today is progressive. However, I would caution against an approach that says that every change to the tax code should itself be progressive.

There are certain inefficiencies that rise as the progressivity of the tax code increases. In particular, there is evidence looking at entrepreneurship and that a progressive rate structure where success is taxed at a higher rate than the failures that are often associated with entrepreneurship, that that convexity of the tax rate structure can discourage entrepreneurship and economic growth.

In other words, I think it is appropriate and good that the system is progressive, but we have to be careful at the limit.

The CHAIRMAN. Thank you.

Mr. Ponnuru, we will let you sum up here.

Mr. PONNURU. I do think that there are concerns about excessive progressivity, partly because it can sometimes lead to a more volatile tax base. I think that that is something that, for example, the State and local deduction tends to reward on the part of the States, that encourages them to have more progressive systems of taxation that are more volatile.

The CHAIRMAN. Thank you. I want to thank all four of you for being here today. It has been an interesting hearing. I think all of our people had a fairly reasonable chance to ask the questions that are really bothering them.

Now, we just barely scratched the surface, I know, but to the extent that you have contributed, as you have, it has been a wonderful thing for us. So I appreciate all of you.

With that, we will recess until further notice.

[Whereupon, at 12:30 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Lily L. Batchelder,[1] Professor of Law and Public Policy, New York University School of Law

Good morning, Mr. Chairman, Ranking Member Wyden, and members of the committee. My name is Lily Batchelder, and I am a professor at NYU School of Law. Thank you for the opportunity to testify before you today on individual tax reform. It is a pleasure and honor to be back with the committee.

There are three traditional goals of tax reform: greater equity, efficiency, and simplicity. Sometimes these goals are in tension; at other points, they can be furthered at the same time. In my view, individual tax reform should focus on areas where we are farthest from these goals, and where we can advance more than one simultaneously. My testimony makes five main points:

- The current tax reform effort is occurring at a time when low- and middle-income families are facing deep financial challenges. Economic disparities in the United States are vast and have been widening for decades. The United States also has one of the lowest levels of economic mobility among our competitors. Our debt as a share of GDP is projected to grow to unprecedented levels in coming decades, largely because of the retirement of the Baby Boom generation and increasing life expectancy. This growth in national debt will be a drag on economic growth. For all these reasons, tax reform should increase revenues and enhance progressivity. Doing so would boost economic growth and make the tax code fairer at the same time. At a bare minimum, tax reform should maintain the current level of revenues and progressivity, which should be measured consistently and without resort to budget gimmicks like a "current policy" baseline.
- Individual tax reform should focus on leveling the playing field for the next generation and supporting work. Doing so would blunt economic inequality, broaden economic opportunity, and increase efficiency and productivity by ensuring that jobs are awarded more often based on effort and talent, and less often based on connections and the luck of one's birth. Some worthwhile proposals that would advance these goals are expanding the EITC, especially for workers without dependents; increasing refundability of the child tax credit, especially for young children in the poorest families; and restructuring child care benefits so they provide the largest benefits to families for whom child care costs impose the greatest budgetary strain. These proposals could make significant headway in offsetting the much lower earnings growth experienced by low- and moderate-income families over the past few decades relative to those who are more affluent. They should be paid for by raising taxes on the most fortunate, including by strengthening, not repealing, wealth transfer taxes.
- Individual tax reform should also focus on reducing transactional complexity, which arises from taxpayers reorganizing their affairs to minimize taxes. Reducing transactional complexity essentially involves eliminating opportunities for savvy taxpayers to game the tax system and accomplishes the trifecta of tax reform: it makes the tax code fairer, more efficient, and simpler. To further this goal, Congress should consider proposals like rationalizing the NIIT and SECA taxes so all labor and capital income are subject to the Medicare tax on high

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[1] I am grateful to Seth Hanlon, Chye-Ching Huang, David Kamin, and Greg Leiserson for helpful comments, and Cameron Williamson for excellent research assistance. All errors are my own.

incomes in some form, repealing stepped-up basis, narrowing the gap between the tax rates on ordinary income and capital gains, and taxing carried interest as ordinary income.

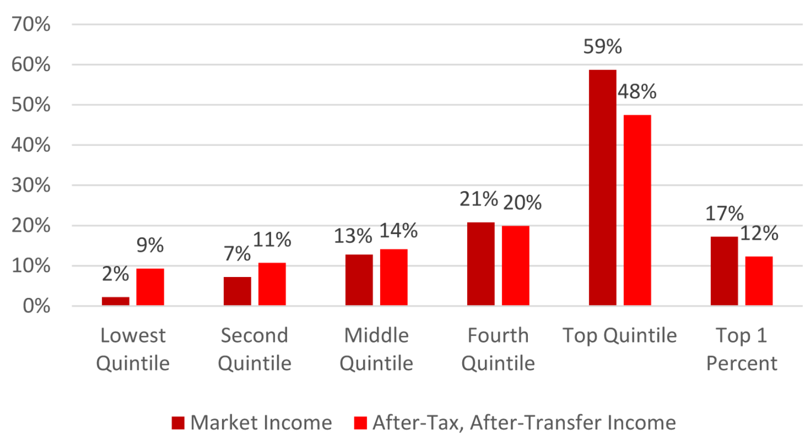
- Individual tax reform should further seek to make tax incentives more efficient and fair, generally by restructuring them into refundable tax credits and leveraging empirical insights from behavioral economics. Doing so could generate more social benefits at a lower cost. One particularly fruitful area for reform is tax incentives for retirement savings. By reducing tax benefits for the wealthy, increasing them for low- and middle-income workers, and ensuring that all workers have access to an easy way to save at their workplace through automatic IRAs, Congress could increase retirement security for millions of Americans while raising revenue at the same time.
- Unfortunately the tax plans offered to date by President Trump and the House GOP leadership move precisely in the opposite direction. Both lose massive amounts of revenue. The corresponding increase in debt would depress economic growth over time. They are also sharply regressive, providing vast tax cuts to the wealthy and a pittance to everyone else. They create a giant new loophole for the wealthy in the form of a special rate cap on pass-through business income, which tax experts on the left and right agree is a terrible idea. To the extent that they include proposals intended to support low- and middle-income households, they do so in relatively ineffective ways. Moreover, sooner or later, these plans' massive tax cuts for the wealthy will have to be paid for, and low- and middle-income families are likely to be left footing the bill. I urge you to consider a fundamentally different approach.

I. INDIVIDUAL TAX REFORM SHOULD ENHANCE PROGRESSIVITY AND INCREASE REVENUES

A. The Context of Tax Reform

The current tax reform effort is occurring at time when low- and middle-income families are facing deep financial challenges. Economic disparities in the United States are vast and have been widening for decades. As illustrated in Figure 1, the top 1% earns more than 17% of all market income.

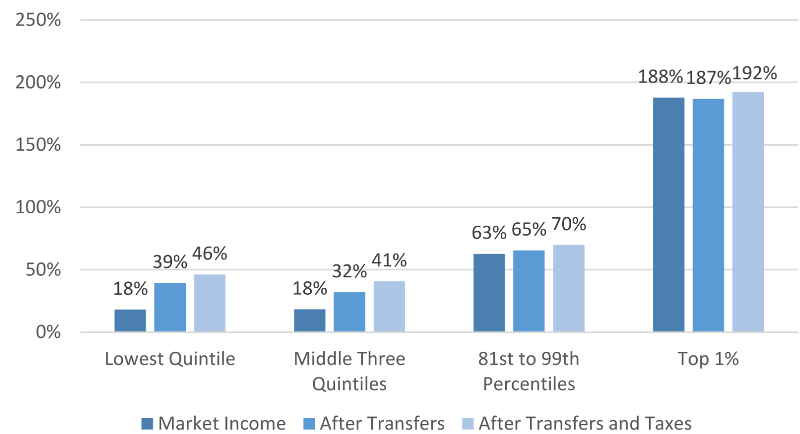
Figure 1: Shares of Market Income and After-Tax, After-Transfer Income, 2013



Source: CONG. BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2013 (June 8, 2016).

Tax cuts and especially changes to direct spending programs have played an important role in boosting the incomes for low- and middle-income households over the past several decades. But the after-tax, after-transfer income of the top 1% has still grown about four times faster than it has for low- and middle-income households, as shown in Figure 2. The situation is even worse for working-class households, defined as those in which no one has a bachelor's degree. Real median after-tax, after-transfer income for a working-class household of three has only grown 3% since 1997.[2]

Figure 2: Cumulative Growth in Inflation-Adjusted Household Income from 1979 to 2013



Source: CONG. BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2013 (June 8, 2016).

These disparities might be justified if they purely reflected people's efforts and choices. But the United States actually has one of the lowest levels of intergenerational economic mobility among our competitors. In the United States, a father on average passes on roughly half of his economic advantage or disadvantage to his son. Among our competitors, the comparable figure is less than one-third, and for several it is one-fifth.[3] This implies that, to an especially large extent in the United States, economic disparities reflect the luck of one's birth, not hard work.

Compounding these challenges, our national debt as a share of GDP is projected to grow to unprecedented levels in the coming decades, as shown in Figure 3. This is largely due to the retirement of the Baby Boom generation and increasing life expectancy—not policy choices. These demographic trends increase Medicare, Medicaid, and Social Security costs, contribute to health-care costs rising more rapidly than inflation, and reduce the proportion of the population that contributes to the trust funds for these programs.

The solution will need to involve more revenues. As groups ranging from the National Academy of Sciences[4] to the Bipartisan Policy Center[5] to the American Enterprise Institute[6] have concluded, revenues will need to rise as a share of GDP and increase relative to current law. The later we act to stabilize our long-term fiscal outlook, the larger the costs will be, and the more likely it is that we will partially renege on fundamental commitments to low- and middle-income workers in their retirement through cuts to Social Security, Medicare, or Medicaid law.[7]

[2] Chuck Marr, Brandon DeBot, and Emily Horton, "How Tax Reform Can Raise Working-Class Incomes," Center on Budget and Policy Priorities (September 13, 2017).

[3] Miles Corak, "Income Inequality, Equality of Opportunity, and Intergenerational Mobility," 27 *Journal of Economic Perspectives* 3, 79 (2013).

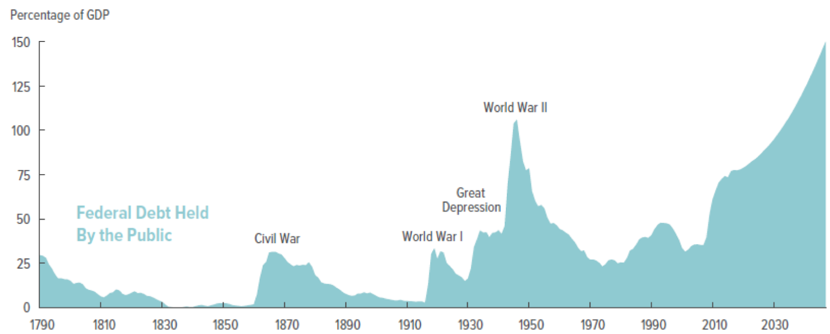
[4] National Research Council and National Academy of Public Administration, *Choosing the Nation's Fiscal Future* (2010); "Setting and Meeting an Appropriate Target for Fiscal Sustainability: Hearing Before the Senate Committee on the Budget," 111th Congress (February 11, 2010) (statement of Rudolph G. Penner, Institute Fellow, Urban Institute).

[5] Bipartisan Policy Center, "A Bipartisan Approach to America's Fiscal Future" (2015), *http://www.pgpf.org/sites/default/files/05122015_solutionsinitiative3_bpc.pdf.*

[6] Joseph Antos, Andrew Biggs, Alex Brill, and Alan Viard, "A Balanced Plan for Fiscal Stability and Economic Growth," American Enterprise Institute (2015), *http://www.pgpf.org/sites/default/files/05122015_solutionsinitiative3_aei.pdf.*

[7] For further discussion of these issues, *see* Paul N. Van de Water, "Federal Spending and Revenues Will Need to Grow in Coming Years, Not Shrink," Center on Budget and Policy Priorities (September 6, 2017).

Figure 3: Historical and Projected Federal Debt as a Share of GDP



Source: CONG. BUDGET OFFICE, THE LONG-TERM BUDGET OUTLOOK (March, 2017).

For all these reasons, I believe tax reform should enhance progressivity and increase revenues. Doing so would make the tax code fairer and boost economic growth at the same time. JCT and CBO have estimated that deficit-financed individual income tax cuts, including those disproportionately benefiting the wealthy, reduce growth by driving up private borrowing costs in the long-term.[8] This implies that progressive, revenue-enhancing reforms would increase economic growth. In addition, such reforms would strengthen the tax code's ability to automatically stabilize the economy in recessions, potentially shortening downturns and mitigating their negative long-term effects on the economy.[9]

At a bare minimum, individual tax reform should do no harm: it should at least maintain the level of revenues and progressivity under current law. Revenue and distributional neutrality were the shared, bipartisan premises of the last major tax reform in 1986, and they are all the more critical basic standards today for the reasons laid out above.

B. The Importance of Accurately Measuring Revenues and Progressivity

In determining whether tax reform maintains or increases revenues, it is critical that revenues are measured consistently and without resorting to budget gimmicks. This means first and foremost that revenues should be measured relative to current law, not so-called "current policy."

At the end of 2015, Congress deliberately allowed many of the "tax extender" provisions to expire while making others permanent. The largest provision set to expire—bonus depreciation—was expressly intended as a temporary, stimulative policy when originally enacted.

Some have suggested adopting a current policy baseline for tax reform. Such a baseline would assume that all of these tax cuts currently set to expire—and potentially a host or provisions that have already expired—are actually permanent law, even though making them permanent would cost as much as $450 billion over the next decade, as illustrated in Figure 4.[10] As a result, a bill that cuts taxes by $450 billion could be treated as not cutting taxes at all. Adopting a current policy base-

[8] Congressional Budget Office, "The Economic Outlook and Fiscal Policy Choices," Hearing before the Senate Committee on the Budget, 111th Congress 8 (2010) (statement of Douglas W. Elmendorf, Director, Congressional Budget Office); Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief" (March 1, 2005), *http://www.jct.gov/x-4-05.pdf.*

[9] For discussions of the macroeconomic benefits of progressive taxes as automatic stabilizers, *see* Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stan. L. Rev.* 23 (2006); Yair Listokin, "Stabilizing the Economy Through the Income Tax Code," *Tax Notes* (June 29, 2009); Douglas W. Elmendorf and Jason Furman, "If, When, How: A Primer on Fiscal Stimulus" (The Hamilton Project, January 2008).

[10] Congressional Budget Office, "Detailed Revenue Projections" (June 2017), *https://www.cbo.gov/about/products/budget-economic-data#7.*

line for budget scoring purposes would be set a terrible precedent and would fundamentally undermine our system of budget enforcement.

Figure 4: Components of Potential "Current Policy" Baseline

Source: Committee for a Responsible Federal Budget, *Current Policy Gimmick Would Add Half-Trillion to Debt* (Aug. 30, 2017).

The problem with a current policy baseline is not strictly with treating temporary changes as permanent, but with doing so inconsistently.[11] To be sure, when some expiring spending programs are extended, their extension is treated as having no budgetary effect. But this is done consistently. Such a program is only treated as permanent in the baseline, and therefore having no budgetary effect when extended, if it was treated as permanent for budget scoring purposes when first enacted.

In contrast, Congress has traditionally applied a "current law baseline" when determining the budgetary effects of tax changes. When the tax extenders in place today were first enacted (or were extended), they were not treated as permanent tax cuts for budget scoring purposes. As a result, it would be fundamentally inconsistent to assume that making them permanent now has no budgetary cost. In fact, there is now some talk of both using a current policy baseline, which assumes that existing temporary provisions are permanent, and then scoring new temporary tax cuts as temporary all in the same bill—the ultimate fiscal shell game. By this logic, Congress could repeal all Federal taxes for 2018 only and estimate the cost at the roughly $3.6 trillion the Federal Government is expected to raise in 2018, using the current law baseline it has traditionally used for tax legislation. Then, in 2018, Congress could permanently repeal all Federal taxes and, if the Budget Committee chair declared that Congress was shifting to a current policy baseline for tax purposes, the permanent elimination of all Federal taxes would be treated as having no budgetary effects whatsoever.

In determining the revenue effects of tax reform legislation, it is also critical for Congress to avoid timing gimmicks. To be sure, there are reasonable policy changes that have bigger or smaller budgetary effects within the budget window than they do outside it. But such changes should be enacted because they are substantive policy improvements, not as pretext to hide the cost of tax cuts. Congress should therefore be careful to consider the revenue effects both inside and outside the budget window.

In this respect, the Byrd rule serves as an important backstop. It provides that any tax legislation enacted through the reconciliation process (thereby avoiding a filibuster) cannot increase deficits in any year outside the budget window. But it is

[11] For further discussion, *see* David Kamin and Rebecca Kysar, "All About That Base(line)" (September 1, 2017) (working paper).

also important that any tax bill increases, or at a bare minimum maintains, the current law level of revenues within the budget window. The Byrd rule does not cover deficit increases within the budget window, but the Senate's "pay-go" rule does, and that rule should not be discarded to allow for deficit-increasing tax cuts.[12]

In addition, tax reform legislation should respect the underlying intent of the Byrd rule (and the reconciliation process itself), which was to reduce deficits, not increase them. This is yet another argument for continuing to use a current law baseline for tax purposes. It also means that if any bill includes provisions that raise more revenue within the budget window than outside it (such as the mandatory "Rothification" of all future contributions to retirement plans), the Senate should be absolutely sure to secure estimates of the revenue effects of the bill outside the budget window before voting. Such out-year estimates are necessary to ensure that any such bill complies with both the letter and spirit of the Byrd rule.

Turning to progressivity, there is broad agreement among tax experts that changes in progressivity should be measured by looking at the percent change in after-tax income for different income groups.[13] The progressivity measure should also incorporate all Federal taxes, including the corporate income tax and wealth transfer taxes, and should distribute those taxes in line with the methodology adopted by the nonpartisan career staff at JCT, CBO and the Treasury Department. In this regard, recent suggestions that corporate income tax cuts should be distributed in a dramatically different manner from the consensus approach of these nonpartisan professionals are deeply disturbing.[14]

One alternative measure of progressivity that is particularly misleading is the percent change in tax liabilities. This measure makes regressive tax cuts look like progressive cuts. For example, it implies that if a minimum wage worker sees her income tax liability fall from $100 to $49, she is receiving a larger tax cut than a millionaire whose tax liability is cut from $200,000 to $100,000. Conversely, it is also misleading to look only at dollar changes in tax liability because this measure can make a progressive tax cut look like a regressive one. For example, it implies that if a family earning $25,000 receives a $1,000 tax cut and a family earning $1 million receives a $1,001 tax cut, this is a regressive tax change.

Continuing to use a current law baseline is also critical for measuring whether tax legislation maintains or increases progressivity. The tax cuts that have recently expired or are slated to expire disproportionately benefit the wealthy. They are mostly corporate tax cuts, and on average, they provide three times as large a tax cut for the top 1% as they do for the bottom four quintiles, when the tax cut is measured as a share of after-tax income.[15] Thus, assuming that these expired and expiring provisions are already permanent would involve assuming that the tax code is currently less progressive than it actually is.

If Congress increases or, at a bare minimum, maintains the current level of revenues and progressivity as defined here, any tax reform legislation will abide by the so-called Mnuchin principle, which I fully support. Treasury Secretary Steve Mnuchin has stated several times that "there will be no absolute tax cut for the upper class . . . any tax cuts we have for the upper class will be offset by less deductions that pay for it."[16] In light of mounting inequality and deficits, tax reform should not provide a net tax cut to the wealthy. Instead, it should increase taxes

[12] *See, e.g.,* Alan Cohen, "The Potential Impact of PAYGO Rules on Tax Legislation," Center for American Progress (August 28, 2017), *https://www.americanprogress.org/issues/economy/reports/2017/08/28/437873/potential-impact-paygo-rules-tax-legislation/*.

[13] *See, e.g.,* Scott Greenberg, "Distributional Effects Should Be Measured in Percentages, Not Dollars," Tax Foundation (November 5, 2015), *https://taxfoundation.org/distributional-effects-should-be-measured-percentages-not-dollars/*. For a detailed explanation of why this is the best measure of tax progressivity, *see* David Kamin, "What is a Progressive Tax Change?: Unmasking Hidden Values in Distributional Debates," 83 *NYU L. Rev.* 241 (2008).

[14] Richard Rubin, "Who Ultimately Pays for Corporate Taxes? The Answer May Color the Republican Overhaul," *Wall Street Journal* (August 8, 2017).

[15] Chye-Ching Huang and Brandon DeBot, "'Current Policy' Baseline Would Hide $439 Billion in Tax Cuts Worth at Least $40,000 a Year for the Top 0.1 Percent," Center on Budget and Policy Priorities (August 16, 2017).

[16] *Squawk Box* (CNBC television broadcast, November 30, 2016), *http://www.cnbc.com/2016/11/30/cnbc-transcript-steven-mnuchin-and-wilbur-ross-speak-with-cnbcs-squawk-box-today.html. See also Tucker Carlson Tonight* (Fox News television broadcast, April 26, 2017), *http://www.foxnews.com/politics/2017/04/26/mnuchin-trumps-tax-plan-is-middle-income-tax-cut.html.*

on the wealthy and use some of the revenues raised for deficit reduction and some to boost the take-home pay of those who are less fortunate.

C. Proposals to Date by the President and House Republicans Go in the Wrong Direction

Unfortunately the proposals offered to date by President Trump and the House Republican Blueprint [17] move exactly in the wrong direction on revenues and progressivity. Both lose vast amounts of revenue. The Tax Policy Center has estimated that the President's most recent plan would lose at least $3.5 trillion over 10 years,[18] and that earlier, more detailed versions of his plan would lose $6.2 trillion.[19] Just last month, the President said that he plans to enact the "biggest tax cut in the history of our country." [20] The House GOP Blueprint would lose $3.1 trillion over 10 years.[21]

Because of these massive revenue losses and the corresponding increase in deficits, the Tax Policy Center estimates that both plans would depress economic growth over time.[22] While JCT and CBO have not released estimates of either plan, their prior estimates imply that they would also find that both plans would reduce long-term economic growth.[23]

In addition, both plans are sharply regressive. Directly contradicting the Mnuchin principle, on average they provide massive tax cuts to the wealthiest Americans, including those who inherit vast sums of money, while providing a relative pittance to everyone else, as shown in Figure 5. The top 1% receives an average tax cut of 12–13% of their income under both plans, while the bottom four quintiles only receive average tax cuts of 0–2% of their after-tax income. Overall, the top 1% receives about half of the value of the tax cuts under the most recent Trump plan, and about three-quarters of the tax cuts under the House GOP Blueprint.[24]

Sooner or later, these massive tax cuts for the wealthy will have to be paid for, and low- and middle-income families are likely going to be left paying the tab. As illustrated in Figure 6, if the President's plan were eventually paid for by tax increases or spending cuts that were proportionate to income, 82% of households would be worse off—but not the most affluent.[25] And this outcome is probably less regressive than it would be if the tax cuts were paid for, either now or in the future, with the types of budget cuts called for in President Trump's and the House Budget Committee's budgets.

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[17] "A Better Way: Tax Reform Task Force Report" 25–26 (June 24, 2016), *http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.*

[18] TPC Staff, "The Implications of What We Know and Don't Know About President Trump's Tax Plan," Tax Policy Center (July 12, 2017).

[19] Jim Nunns et al., "An Analysis of Donald Trump's Revised Tax Plan," Tax Policy Center (October 18, 2016).

[20] Blair Guild, "Trump Lashes out During Combative Speech at Campaign-Style Rally in Phoenix," CBS News (August 22, 2017), *https://www.cbsnews.com/news/trump-holds-make-america-great-again-rally-in-phoenix/*.

[21] Benjamin R. Page, "Dynamic Analysis of the House GOP Tax Plan: An Update" (June 30, 2017).

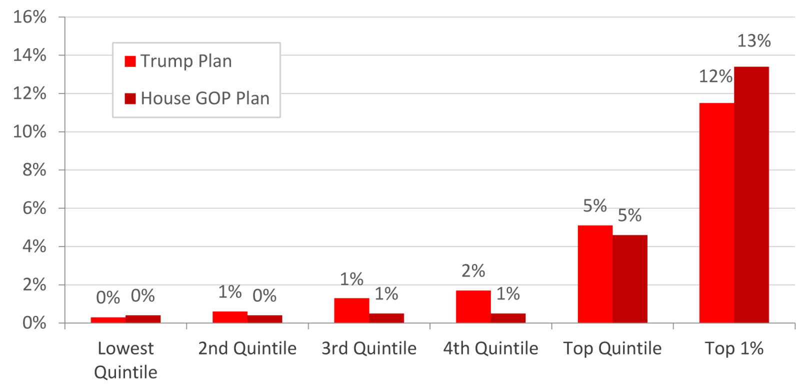
[22] *Id.* (estimating that the House GOP Blueprint would reduce GDP by 1% to 2.6% by 2036); TPC Staff, "The Implications of What We Know and Don't Know about President Trump's Tax Plan," Tax Policy Center (July 12, 2017).

[23] *See* Congressional Budget Office, "The Economic Outlook and Fiscal Policy Choices," Hearing before the Senate Committee on the Budget, 111th Congress 8 (2010) (statement of Douglas W. Elmendorf, Director, Congressional Budget Office); Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief" (March 1, 2005).

[24] Tax Policy Center, "T17–0192: Distributional Effects of Proposals Related to the Trump Administration's 2017 Tax Plan; Tax Cut and Possible Revenue Raising Provisions, by Expanded Cash Income Percentile, 2018," Tax Policy Center (July 12, 2017), *http://www.taxpolicycenter.org/model-estimates/proposals-related-trump-administrations-2017-tax-plan-july-2017/t17-0192;* Burman et al., "An Analysis of the House GOP Tax Plan," *Columbia Journal of Tax Law* (2017).

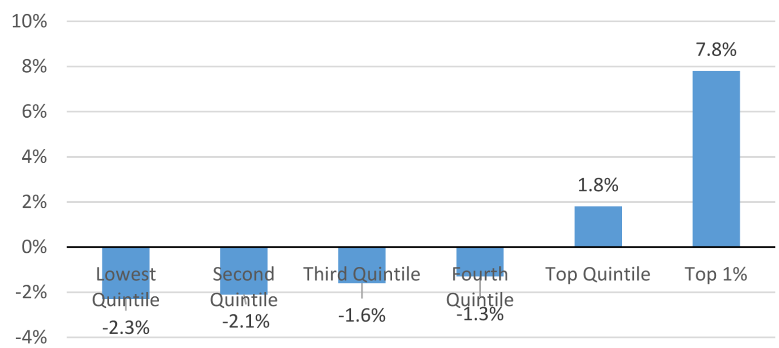
[25] William Gale et al., "Cutting Taxes and Making Future Americans Pay for It: How Trump's Tax Cuts Could Hurt Many Households," Tax Policy Center (August 15, 2017).

Figure 5: Percent Change in After-Tax Income under Trump Plan and House GOP Blueprint



Sources: Tax Policy Center, *Table T17-0192* (July 12, 2017); Burman et al., *An Analysis of the House GOP Tax Plan*, COLUMBIA J. OF TAX L. (2017).

Figure 6: Percent Change in After-Tax Income under Trump Plan if Eventually Paid for by Tax Increases or Spending Cuts Proportionate to Income

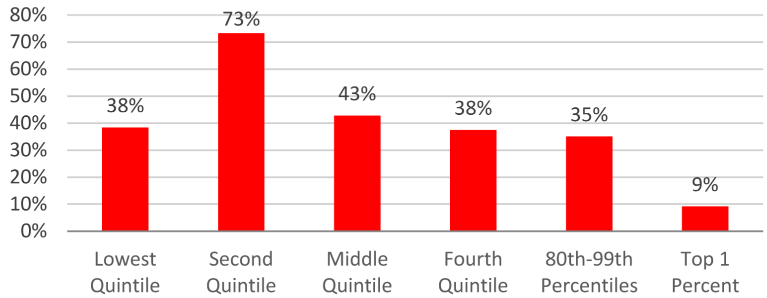


Source: William Gale et al., *Cutting Taxes and Making Future Americans Pay for It: How Trump's Tax Cuts Could Hurt Many Households*, TAX POLICY CTR. (Aug. 15, 2017).

Another possibility is that low- and middle income families will actually see their taxes immediately go up as part of tax reform, paying for tax cuts for the wealthy right away. Indeed, the Tax Policy Center estimates that an astonishing 45% of families with children—and 70% of single parents—would see their taxes go up in 2018 under the President's most recent tax plan, as summarized in Figure 7.[26] This is all the more stunning when one considers that his plan reduces revenues by about $3.5 trillion, and that he has had numerous opportunities to address these tax increases as his tax plan has evolved but has not even bothered.

[26] Tax Policy Center, "T17–0192: Distributional Effects of Proposals Related to the Trump Administration's 2017 Tax Plan; Tax Cut and Possible Revenue Raising Provisions, by Expanded Cash Income Percentile, 2018," Tax Policy Center (July 12, 2017). This is largely due to his proposals to repeal personal exemptions and head of household filing status, and also because of the ways in which he proposes to consolidate the tax brackets. Using a slightly different methodology and focusing on his 2016 tax plan, I previously estimated that 21–28% of families with children and 51–61% of single parents would face a tax increase under the President's plan. Lily L. Batchelder, "Families Facing Tax Increases Under Trump's Tax Plan," Tax Policy Center (October 28, 2016).

Figure 7: Share of Families with Children Facing Tax Increase under Trump Plan in 2018



Source: Tax Policy Center, *Table T17-0192* (July 12, 2017).

The President and House GOP leadership have said that they intend for their tax plans to focus their benefits on middle-class families and, at times, that their tax plans will be revenue-neutral.[27] I very much hope this is the case. But it is deeply concerning that thus far they have proposed very specific and massive tax cuts for the wealthy, while being quite non-specific about how they would pay for these tax cuts or meaningfully invest in the middle class.

D. Better Approaches

In contrast to the plans offered to date by President Trump and the House GOP Blueprint, I urge the committee to consider raising more revenue through individual tax reform by increasing effective tax rates on the wealthy, including by adopting the revenue raising proposals discussed below.

Any tax cuts that are part of individual tax reform should be focused on low- and middle income households, and should therefore generally be structured as refundable tax credits. Cutting tax rates or increasing deductions and exemptions tends to disproportionately benefit the wealthy. This is because the value of a deduction or exemption is the amount deducted times the taxpayer's marginal tax rate, which tends to rise with income. This is also true of proposals to raise the income thresholds for the tax brackets—the value is the amount of the increase in the threshold times the taxpayer's marginal tax rate. Only a refundable tax credit de-links tax benefits from a household's marginal tax rate.

As an example of the problem with deductions and raising the thresholds for tax brackets, consider the proposal to substantially increase the standard deduction by President Trump and the House GOP leadership. Both have promoted this proposal as a core element of their plan for low- and moderate-income households.[28] But it is much less valuable for such households than a refundable credit of equivalent cost. Increasing the standard deduction is worth nothing to the 35% of households who already fall in the zero bracket (*i.e.,* their income is less than the standard deduction and personal exemptions).[29] Among non-itemizers with income above the zero bracket, it is worth more to those in higher brackets, who tend to be higher income. To be sure, increasing the standard deduction also provides no benefit to households whose itemized deductions exceed the new, larger standard deduction, and these families tend to be wealthier. But the point remains that increasing the standard deduction is a poorly designed way to support low- and middle-income

[27] *See, e.g.,* Donald Trump, "The Inaugural Address," The White House, January 20, 2017, *https://www.whitehouse.gov/inaugural-address* ("Every decision on . . . taxes . . . will be made to benefit American workers and American families."); Luca Gattoni-Celli, "Mnuchin Reaffirms Support for Revenue-Neutral Tax Reform," *Tax Notes* (June 14, 2017); Naomi Jagoda, "Brady Makes the Case for Revenue-Neutral Tax Reform," *The Hill* (January 25, 2017).

[28] *See, e.g.,* Office of the Press Secretary, Remarks by President Trump on Tax Reform (September 6, 2017), *https://www.whitehouse.gov/the-press-office/2017/09/06/remarks-president-trump-tax-reform* ("[W]e will provide tax relief to middle-income families through a combination of benefits, such as raising their standard deduction . . .").

[29] Tax Policy Center, "T16–0085: Number of Tax Units by Tax Bracket and Filing Status," Tax Policy Center (July 6, 2016), *http://www.taxpolicycenter.org/model-estimates/baseline-distribution-tax-units-tax-bracket-july-2016/t16-0085-number-tax-units-tax.*

households, and provides little or no benefit to those who are financially struggling the most.

II. INDIVIDUAL TAX REFORM SHOULD SEEK TO LEVEL THE PLAYING FIELD AND SUPPORT WORK

In addition to increasing revenues and progressivity, individual tax reform should focus on leveling the playing field for future generations and supporting work. Doing so would blunt economic inequality, broaden economic opportunity, and increase productivity by ensuring that jobs are awarded more often based on effort and talent, and less often based connections and the luck of one's birth. Reforms advancing these goals would make the tax code fairer and more efficient simultaneously. They could also be structured in ways that are relatively simple.

A. The First Goal: Do No Harm

The first goal in this area should be to do no harm. Unfortunately, once again the proposals offered by President Trump and the House GOP Blueprint to date move in precisely the wrong direction. As discussed, their plans are sharply regressive. This means that they not only will exacerbate growing economic disparities, but also will probably reduce intergenerational economic mobility over time. Lower levels of income inequality are generally correlated with higher levels of intergenerational economic mobility.[30] Put differently, if tax reform raises taxes on the wealthy and uses part of the revenues raised to boost the living standards of low- and middle-income families, this doesn't just benefit such families now. It also means that their children are likely to do better because their economic success will be less heavily impacted by the economic status of their parents.

In addition to substantially reducing tax progressivity, both plans counterproductively repeal wealth transfer taxes, including the estate tax, when such taxes are actually one of the most important features of the tax system for making the economic playing field somewhat more level.[31] As discussed, the United States has one of the highest levels of opportunity inequality among our competitors. The enormous inequality of financial inheritances worsens this inequality of life chances dramatically. Indeed, 30% of the correlation between parent and child incomes—and more than 50% of the correlation between the wealth of parents and their children—is attributable to financial inheritances.[32] This is far more than the impact of IQ, personality, and schooling combined. In short, when researchers have tried to boil down inequality of opportunity to one factor, it is about financial inheritances.

If financial inheritances drive economic opportunity this much, one would think the tax code would try to soften their effects. Instead, on average, we actually tax inheritances at only about one-quarter of the rate at which we tax income from work and savings, as summarized in Figure 8. If a wealthy individual bequeaths assets with $100 million unrealized gains, neither that individual nor his heirs ever have to pay income or payroll tax on that $100 million gain due to stepped-up basis. In addition, the recipients of such large inheritances never have to pay income or payroll tax on the total amount they inherit, whether attributable to unrealized gains or not. The only taxes that such lucky heirs may bear are wealth transfer taxes, which experts on the both sides of the aisle agree are largely borne by the heirs of large estates, not the decedent.[33]

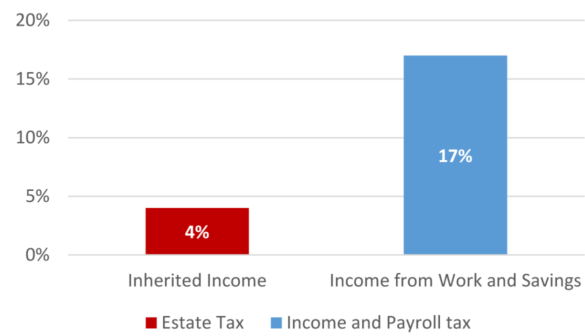
[30] Corak, *supra* note 3; Raj Chetty, et al., "Is the United States Still a Land of Opportunity? Recent Trends in Intergenerational Mobility" 11 (National Bureau of Economic Research, Working Paper No. 19844, 2014).

[31] This discussion of wealth transfer taxes draws on Lily L. Batchelder, "What Should Society Expect From Heirs? The Case for a Comprehensive Inheritance Tax," 63 *Tax Law Review* 1 (2009); Lily L. Batchelder, "The 'Silver Spoon' Tax: How to Strengthen Wealth Transfer Taxation," in *Delivering Equitable Growth: Strategies for the Next Administration* (Washington Center for Equitable Growth, 2016); and Lily L. Batchelder, "Fixing the Estate Tax," 43 *Democracy* (Winter, 2017).

[32] Samuel Bowles, Herbert Gintis, and Melissa Osborne Groves, Introduction to *Unequal Chances: Family Background and Economic Success* 18–19 (2005) (finding that financial inheritances account for 30% of the parent-child income correlation, while parent and child IQ, schooling, and personality combined account for only 18%); Adrian Adermon, Mikael Lindahl, and Daniel Waldenstrom, "Intergenerational Wealth Mobility and the Role of Inheritance: Evidence From Multiple Generations" (July 26, 2016) (working paper) (finding that bequests and gifts account for at least 50% of the parent-child wealth correlation, while earnings and education account for only 25%).

[33] *See, e.g.,* N. Gregory Mankiw, Remarks at the National Bureau of Economic Research Tax Policy and the Economy Meeting from Council of Economic Advisers (November 4, 2003) ("As a first approximation, it would make more sense to distribute the burden of the tax to the estate's beneficiaries rather than to the decedent"). For an explanation of why this is the case,

Figure 8: Average Tax Rate on Inherited Income versus Income from Work and Saving, 2009



Source: Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1 (2009).

Wealth transfer taxes are not only essential to leveling the playing field, but they are also the most progressive component of the Federal tax system. Currently they only apply to the top 0.2% of estates[34] because the exemption is extremely high: $11 million per couple in 2017, and probably more than $16 million if a couple takes full advantage of the annual gift exclusion,[35] not to mention other planning opportunities. Contrary to the talking points of estate tax opponents, neither the American Farm Bureau nor *The New York Times* have been able to identify a single case of a farm actually being sold to pay the estate tax, even when the exemption was one-sixteenth of the current level and the rate was 55%.[36] The estate tax also has strong positive effects on charitable giving. When the estate tax was repealed for 1 year in 2010, charitable bequests fell by 37%.[37] Moreover, repeal would cost $270 billion over 10 years, further jeopardizing our long-term fiscal outlook.[38]

By dramatically cutting taxes for the most affluent and repealing wealth transfer taxes, the plans advanced by President Trump and the House GOP Blueprint therefore fail to level the playing field at the top, instead magnifying the advantages of the most fortunate. At the same time, to the extent that these plans include proposals intended support low- and middle-income households, they do so in relatively ineffective ways.

For example, President Trump's proposals in 2016 to expand tax benefits for child care disproportionately benefit higher-income families.[39] They increase tax complexity by increasing the number of child-care-related tax benefits from two to five.

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see Lily L. Batchelder and Surachai Khitatrakun, "Dead or Alive: An Investigation of the Incidence of Estate Taxes and Inheritance Taxes" (2008) (working paper).

[34] Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System" (March 16, 2015), *https://www.jct.gov/publications.html?func=startdown&id=4744*.

[35] This assumes that a couple makes annual gifts equal to the annual exclusion for 50 years, the annual exclusion is constant (although it is actually inflation-adjusted), and the interest rate is 5%.

[36] David Cay Johnston, "Talk of Lost Farms Reflects Muddle of Estate Tax Debate," *The New York Times* (April 8, 2001).

[37] Sahil Kapur, "GOP Plan to Kill Estate Tax Sets Up Charitable Giving Conflict," *Bloomberg* (August 25, 2017). This is consistent with estimates that permanent estate tax repeal would reduce charitable bequests (which represent 8% of all charitable giving) by 22–37%. Jon M. Bakija and William G. Gale, "Effects of Estate Tax Reform on Charitable Giving," *Tax Policy Center* (July 2003).

[38] Joint Committee on Taxation, "Description of an Amendment in the Nature of a Substitute to the Provisions of H.R. 1105, The Death Tax Repeal Act of 2015" (March 24, 2015), *https://www.jct.gov/publications.html?func=startdown&id=4761*.

[39] Lily L. Batchelder, Elaine Maag, Chye-Ching Huang, and Emily Horton, "Who Benefits From President Trump's Child Care Proposals," Tax Policy Center Research Report (February 28, 2017) (estimating that the average tax cut for families with income under $40,000 would be less than $20, about 3% of all benefits, while about 70% of the benefits would go to families with income over $100,000, and about 25% to families with income over $200,000).

And they provide benefits to higher-income working families with a stay-at-home parent, while arbitrarily excluding similar families who are lower-income.[40]

As discussed, the President's and House GOP's proposals to increase the standard deduction benefits higher-income non-itemizers more than lower-income non-itemizers, and doesn't benefit the lowest-income workers at all. This is despite the fact that low-income workers face some of the highest implicit marginal tax rates, meaning that after taxes, transfers, and work-related costs like child care, it may not pay for them to work at all.[41]

Others have proposed eliminating personal exemptions and/or the head of household filing status in order to pay for a larger child tax credit. But as explained by my fellow witness Ramesh Ponnuru, this may well hurt many low- and middle-income families, rather than helping them.[42] This is especially true if the refundability of the child tax credit were not increased substantially so that more families could claim the full credit.

Finally, recent proposals to double the child tax credit and make it fully refundable against payroll taxes would provide much smaller benefits to lower-income families than higher-income families because they would leave the rate at which low earnings count toward earning the credit virtually unchanged.

B. Reforms Worth Considering

Instead of pursuing the counterproductive or relatively ineffective proposals described above, Congress should instead consider reforms that would meaningfully level the playing field and support work. While there are a host of possibilities, I would like to highlight four options that are especially promising.

The first is expanding the Earned Income Tax Credit (EITC), especially for workers without dependents (sometimes called childless workers). The EITC and child tax credit (CTC) are some of our most effective policies for reducing poverty and increasing employment. In 2013, they kept 8.8 million people out of poverty, including 4.7 million children.[43] The EITC results in about 1 in 10 parents entering the labor force who otherwise would not do so.[44] In addition, mounting evidence suggests that the EITC and CTC improve health outcomes, school performance, educational attainment, and long-term earnings, including for the next generation.[45]

Tax reform should build on the success of these programs. To start, it should address the fact that, as illustrated in Figure 9, childless workers are the only group that is currently taxed into poverty.[46]

Senator Brown and Representative Neal have proposed increasing the maximum EITC for childless workers to $1,400, phasing it in and out more rapidly, and making it available to younger workers.[47] A similar proposal was advanced by former President Obama and endorsed by Speaker Ryan, though it was not included in the House GOP Blueprint.[48] This proposal would subsidize the wages of groups with low or declining labor force participation rates, including men without a college education, young adults not enrolled in school, workers with disabilities, and older

[40] *Id.*

[41] *See, e.g.,* Congressional Budget Office, "Effective Marginal Tax Rates for Low- and Moderate-Income Workers in 2016" (November 2015) (finding that some households earning 100–149% of the poverty line face implicit marginal tax rates of more than 65% when accounting for taxes and some transfers, but not other transfers and work-related costs).

[42] Ramesh Ponnuru, "GOP's Pro-Family Tax Reform Might Have a Catch," *Bloomberg View* (August 28, 2017).

[43] Executive Office of the President and U.S. Treasury Department, "The President's Plan to Help Middle-Class and Working Families Get Ahead" 2 (April 2015).

[44] *Id.,* citing Bruce D. Meyer and Dan T. Rosenbaum, "Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers," 116 *Quarterly Journal of Economics* 1063 (2014).

[45] Chuck Marr, Chye-Ching Huang, Arloc Sherman, and Brandon DeBot, "EITC and Child Tax Credit Promote Work, Reduce Poverty, and Support Children's Development, Research Finds," Center on Budget and Policy Priorities (October 1, 2015).

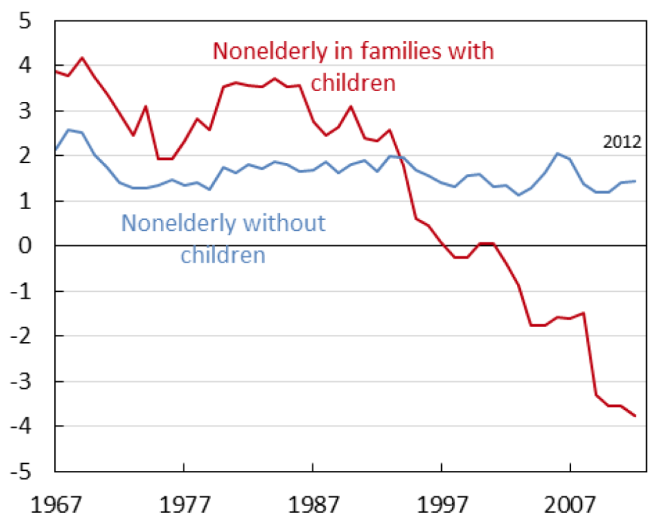
[46] Each year, about 7.5 million working-age adults in the group are taxed into or deeper into poverty. Chuck Marr, Chye-Ching Huang, Cecile Murray, and Arloc Sherman, "Strengthening the EITC for Childless Workers Would Promote Work and Reduce Poverty," Center on Budget and Policy Priorities (April 11, 2016).

[47] S. 1012, 114th Congress (2015); H.R. 902, 114th Congress (2015). Senators Baldwin and Booker have proposed a similar expansion of the EITC for childless workers in S. 3231, 114th Congress (2016).

[48] NBC News, "Meet the Press" transcript, February 1, 2015. *http://www.nbcnews.com/meet-the-press/meet-press-transcript-february-1-2015-n302111.*

workers.[49] As a result, it could meaningfully boost labor force participation. It would lift 600,000 workers out of poverty and lessen the severity of poverty for another 8.7 million.[50] Moreover, the Brown-Neal proposal would essentially ensure that the Federal tax code no longer taxes childless workers into poverty.[51]

Figure 9: Percent Increase (+) or Decrease (-) in Poverty Rate Due to Taxes



Source: Executive Office of the President and the U.S. Treasury Department, The President's Proposal to Expand the Earned Income Tax Credit (March, 2014).

A much more ambitious approach would be to expand the EITC for workers with children as well. For example, Senator Brown and Representative Khanna are proposing a major expansion to the EITC that would roughly double the maximum credit for all groups.[52] Such an expansion would make significant headway toward offsetting the much lower earnings growth that working-class households have experienced over the past few decades relative to comparable families with a bachelor's degrees.[53] While this proposal would cost over $1 trillion,[54] it could be more than paid for by tax increases on the wealthy discussed here and elsewhere. And its cost pales in comparison to the tax cuts for the wealthy contained in President Trump's plan and the House GOP Blueprint.

A second proposal worth considering is strengthening the child tax credit (CTC), especially for low-income families with young children. Currently, the CTC excludes almost 11 million children with working parents because their earnings are too

[49] Executive Office of the President and U.S. Treasury Department, "The President's Proposal to Expand the Earned Income Tax Credit" (March, 2014).
[50] Chuck Marr, Brandon DeBot, and Emily Horton, "How Tax Reform Can Raise Working-Class Incomes," Center on Budget and Policy Priorities (September 13, 2017).
[51] Chuck Marr, Chye-Ching Huang, Cecile Murray, and Arloc Sherman, "Strengthening the EITC for Childless Workers Would Promote Work and Reduce Poverty," Center on Budget and Policy Priorities (April 11, 2016).
[52] Casey Tolan, "Progressive Democrats' Counter-Argument to Trump Tax Plan: a $1.4 Trillion Tax Credit for the Working Class," *Mercury News* (September 12, 2017).
[53] Chuck Marr, Brandon DeBot, and Emily Horton, "How Tax Reform Can Raise Working-Class Incomes," Center on Budget and Policy Priorities (September 13, 2017). A working-class household is defined here as one in which no one has a bachelor's degree. *See also* Neil Irwin, "What Would it Take to Replace the Pay Working-Class Americans Have Lost?", *The New York Times* (December 9, 2016).
[54] Tolan, *supra* note 52.

low.[55] One way to build on the benefits of the CTC for future generations is to eliminate the threshold that currently excludes the first $3,000 of earnings from being counted towards earning the credit and to increase the rate at which the credit can be earned, especially for families with young children, similar to proposals by Senators Baldwin, Bennet, Brown, and Booker.[56] These reforms would target benefits on young children in the poorest households. Children under age 6 are much more likely to live in poverty than other children or adults. Moreover, the evidence that the CTC and similar programs boost children's health, educational, and lifetime earning outcomes is especially strong for the poorest children.[57] For them, more income makes a much bigger difference.

An even more ambitious approach would be to make the CTC fully refundable so that the poorest children could fully benefit even if their parents' have no income, similar to a proposal by Representative DeLauro.[58]

A third reform worth considering is replacing the current law child and dependent care tax benefits with a single refundable tax credit that is larger for families for whom such expenses represent the largest budgetary strain.[59] Child and dependent care costs are a significant financial burden on working families, especially those with low and moderate incomes. On average, the median single mother with children under 5 spends 15% of her earnings on child care, and the median analogous married couple spends 6%.[60] Child care costs have grown dramatically over time, rising 70% in inflation-adjusted terms from 1985 to 2001.[61] Reducing child care costs increases labor force participation by ensuring that caretakers who prefer to engage in market work actually benefit financially from doing so.[62]

One drawback of this proposal is that it would not provide financial support to such families when they need it most: when their child care bills are due. Therefore, while not strictly a tax proposal, an even better reform would be to fully fund child care assistance programs, which provide direct subsidies for child care for low-wage working families.[63] Currently only 15% of families eligible for these subsidies actually receive them because of under-funding; the remaining 85% of families are put on waiting lists.[64] Fully funding this program could be combined with a tax credit for families above the eligibility threshold, as proposed by former President Obama and other researchers.[65]

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[55] Elaine Maag and Julia B. Isaacs, "Analysis of a Young Child Tax Credit," Urban Institute (September 2017).

[56] *See* S. 2264, 114th Congress (2015); S. 3231, 114th Congress (2016). For further discussion of these proposals and similar ones, *see* Chuck Marr, Chloe Cho, and Arloc Sherman, "A Top Priority to Address Poverty: Strengthening the Child Tax Credit for Very Poor Young Children" (August 10, 2016); Maag and Isaacs, *supra.*

[57] *See, e.g.,* Gordon B. Dahl and Lance Lochner, "The Impact of Family Income on Child Achievement: Evidence from the Earned Income Tax Credit," 102 *American Economic Review* 5, 1927–56 (May 2012): Kerris Cooper and Kitty Stewart, "Does Money Affect Children's Outcomes? A Systematic Review," Joseph Rowntree Foundation (October 22, 2013), *https://www.jrf.org.uk/report/does-money-affect-children%E2%80%99s-outcomes.*

[58] H.R. 4693, 114th Congress (2016).

[59] For further discussion of this idea, *see* Lily L. Batchelder, Elaine Maag, Chye-Ching Huang, and Emily Horton, "Who Benefits From President Trump's Child Care Proposals," Tax Policy Center Research Report (February 28, 2017); Katie Hamm and Carmel Martin, "A New Vision for Child Care in the United States," Center for American Progress (September 2015), *https://cdn.americanprogress.org/wp-content/uploads/2015/08/31111043/Hamm-Childcare-report.pdf;* James P. Ziliak, "Supporting Low-Income Workers Through Refundable Child-Care Credits," Hamilton Project: Improving Safety Net and Work Support (2014), *http://www.hamiltonproject.org/assets/legacy/files/downloads_and_links/child_care_credit_ziliak.pdf;* Elaine Maag, "Simplifying Child Care Tax Benefits," Tax Policy Center (2013), *http://www.taxpolicycenter.org/taxvox/simplifying-child-care-tax-benefits.*

[60] Ziliak, *supra.*

[61] Drew DeSilver, "Rising Cost of Child Care May Help Explain Recent Increase in Stay-At-Home Moms," FactTank Blog (April 18, 2014), *http://www.pewresearch.org/fact-tank/2014/04/08/rising-cost-of-child-care-may-help-explain-increase-in-stay-at-home-moms/.*

[62] Council of Economic Advisers, "The Economics of Early Childhood Investments" (2014), *https://obamawhitehouse.archives.gov/sites/default/files/docs/the_economics_of_early_childhood_investments.pdf* (reviewing the literature and concluding that a 10% reduction in child care costs increases maternal employment by 0.5% to 4%).

[63] Currently, the Federal Government provides States funding for child care assistance programs through the Child Care and Development Fund and the Temporary Assistance for Needy Families block grant.

[64] Matthews and Walker, 2016.

[65] Office of Management and Budget, *Budget of the U.S. Government: Fiscal Year 2017* (2016), *https://www.gpo.gov/fdsys/pkg/BUDGET-2017-BUD/pdf/BUDGET-2017-BUD.pdf;* Ajay Chaudry, Taryn Morrissey, Christina Weil, and Hirokazu Yoshikawa, "Cradle to Kindergarten: A New Plan to Combat Inequality" (2017).

Finally, these proposals could be paid for by raising taxes on the most fortunate, including by strengthening, not repealing, wealth transfer taxes. There are at least three ways to strengthen the taxation of financial inheritances that are worth considering. The first is to raise the wealth transfer tax rate above 40%. A second, more fundamental reform would be to replace our current wealth transfer taxes with a direct tax on the recipients of large inheritances. Effectively, the exemption from wealth transfer taxes would then be based on how much an individual inherited, not how much a donor bequeathed. If individuals who inherit more than $2.1 million over their lifetime had to pay income tax plus a 15% surcharge (roughly equivalent to the payroll tax rate) on their inheritances above this threshold, this proposal would raise roughly $200 billion more over 10 years than our current wealth transfer taxes.[66] Lastly, either of these reforms could be coupled with repealing stepped-up basis, which is discussed in more detail in the next section.

III. SIMPLIFYING THE TAX CODE BY REDUCING OPPORTUNITIES FOR GAMING

The third traditional goal of tax reform is simplification. Simplification should certainly be part of individual tax reform, but the policies that meaningfully simplify the tax system are often misunderstood.

David Bradford, the intellectual father of the 1986 Tax Reform Act, distinguished three types of tax complexity: compliance complexity, rule complexity, and transactional complexity.[67] Compliance complexity includes things like is how long it takes to prepare one's tax return and how many records taxpayers have to keep. Rule complexity is how difficult it is to understand what the law is, and can be the result of the tax code being unclear, or unclear administrative guidance and case law. Transactional complexity arises from taxpayers organizing their affairs to minimize their tax liability.

Often transactional complexity is actually the most costly type of tax complexity. But many proposals to simplify the tax code focus on compliance complexity in ways that provide little or no practical benefits for taxpayers. For example, tax plans (including the President's and the House GOP Blueprint) often promise to reduce the number of tax brackets or the number of taxpayers who itemize deductions, heralding these changes as major simplifications. But virtually no taxpayer would notice if there were fewer tax brackets because 90% prepare their returns with computer software or the help of a third party (who generally uses such software).[68] The 10% who still complete their tax returns by hand are instructed by Form 1040 to look up their taxable income on a tax table in order to apply the tax rates, so they are not supposed to do the arithmetic to apply the tax brackets in the first place. Similarly, taxpayers who do not itemize still need to keep records of their State and local taxes, charitable contributions, mortgage interest payments, medical expenses, and the like in order to determine whether they are better off itemizing or claiming the standard deduction. The only way to eliminate these record keeping burdens is to eliminate itemized deductions altogether, which these tax plans do not propose.

Instead, simplification efforts in individual tax reform should focus on reducing transactional complexity, which essentially arises from opportunities for savvy taxpayers to game the tax system. Some tax provisions are meant to change behavior, like the charitable deduction. But other tax provisions sometimes create large, unintended opportunities to reduce or avoid taxes by structuring a transaction or activity in one way, rather than in another, economically identical form. These are what the press frequently refers to as "loopholes."

Reducing such transactional complexity accomplishes the trifecta of tax reform: it makes the tax code fairer, more efficient, and simpler at the same time. It is fairer because generally only taxpayers who can afford high-priced tax advice learn about opportunities to structure their affairs in ways that are economically identical but reduce their taxes. It is more efficient and simpler because taxpayers spend less time trying to figure out how to arrange their affairs to reduce their tax liability, and change their behavior less in response to the tax system.

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[66] Lily L. Batchelder, "The 'Silver Spoon' Tax: How to Strengthen Wealth Transfer Taxation," in *Delivering Equitable Growth: Strategies for the Next Administration* (Washington Center for Equitable Growth, 2016).

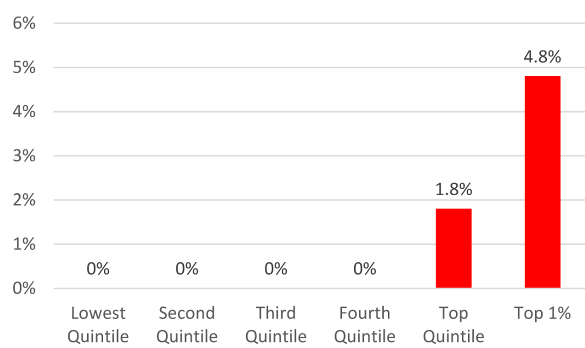
[67] David Bradford, "Untangling the Income Tax," 266–67 (1986).

[68] Susan Jones, "IRS: 90% of Taxpayers Seek Help in Preparing Their Returns," *cnsnews.com* (April 9, 2014), *https://www.cnsnews.com/news/article/susan-jones/irs-90-taxpayers-seek-help-preparing-their-returns.*

A. The First Goal (Again): Do No Harm

Unfortunately several current proposals would dramatically increase transactional complexity. The most alarming is the proposal to apply a new, special cap on the tax rate for pass-through business income.[69] Pass-through business income has always been taxed on individual income tax returns at the same rates as other income. But President Trump has proposed cutting the top rate on pass-through income (and only pass-through income) from 39.6% to 15%, while cutting the top rate on all other ordinary income to 35%. The House GOP Blueprint cuts the top rate on pass-through income to 25%, while cutting the top rate on other ordinary income to 33%.

Figure 10: Percent Change in After-Tax Income under Trump's Proposed Pass-through Rate Cap



Source: Tax Policy Center, *Table T17-0164* (May 15, 2017).

Proponents of this rate cap argue that it would benefit small businesses and rectify the over-taxation of pass-through businesses compared to C corporations. But nothing could be further from the truth. The Tax Policy Center estimates that a full 77% of the benefits of the President's proposal would go to the top 1%,[70] who currently earn more than half of all pass-through income.[71] As illustrated in Figure 10, the average tax cut for the top 1% would amount to 5% of their after-tax income, while the average tax cut for the bottom four quintiles would be zero.

Moreover, the effective marginal tax rate on pass-through businesses is currently about 5 percentage points lower than that on C corporations after accounting for investor-level taxes. This is part of the reason why the share of all business income earned by pass-throughs has risen precipitously, from less than one-quarter in 1980 to 60% today.[72]

A pass-through rate cap would dramatically increase the incentive to characterize income, including compensation for services, as pass-through business income. This is already a significant problem under the current tax code because certain types of pass-through business income are not subject to either payroll or self-employment tax. But it would become much worse. For example, under the President's plan, if a wealthy executive sets up an LLC to receive his $10 million salary, he could save $2 million in taxes. Few middle-class workers have the resources to set up such ve-

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[69] This discussion draws on Lily Batchelder, "Trump's Giant Loophole," *The New York Times* (May 30, 2017).

[70] Urban-Brookings Tax Policy Center Microsimulation Model, "T17–0164—Distributional Effect of a 15-Percent Top Rate on a Broad Definition of Pass-Through Income, Baseline: Current Law With AMT Repealed and 12/25/33 Rate Structure, by Expanded Cash Income Percentile, 2018" (May 15, 2017), *http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0164-distributional.*

[71] Urban-Brookings Tax Policy Center Microsimulation Model, "T17–0080—Sources of Flow-Through Business Income by Expanded Cash Income Percentile; Current Law, 2017" (March 20, 2017), *http://www.taxpolicycenter.org/model-estimates/distribution-business-income-march-2017/t17-0080-sources-flow-through-business.*

[72] The White House and the U.S. Treasury Department, "The President's Framework for Business Tax Reform: An Update" (April 2016), *https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf.*

hicles—and the vast majority would not benefit if they did because they are already in the 15% rate bracket or below.[73] Indeed, the Tax Policy Center and Goldman Sachs estimate that the tax avoidance response would be staggering, accounting for 30–50% of the sizeable cost of the proposal.[74]

For these reasons, tax experts on the left and right agree that it is a terrible idea. For example, experts at the Tax Foundation, which traditionally supports business tax cuts, argue that "the pass-through carve-out primarily incentivizes tax avoidance, not job creation." [75]

B. Reforms Worth Considering

Instead of dramatically increasing transactional complexity, Congress should consider several proposals that would substantially reduce it. The first is reforming the self-employment tax (SECA) and net investment income tax (NIIT) to ensure that all labor and capital income are subject to the Medicare tax on high incomes in some form.

Currently the NIIT and SECA apply a 3.8% to income above $200,000 for single filers and $250,000 for married filers in some cases but not others. They do apply the tax to all employees, owners of sole proprietorships, and "passive" owners of businesses. However, they only apply it in part to "active" owners of S corporations, and often do not apply it at all to "active" owners of LLCs and limited partners.[76] Many high earners (including Newt Gingrich and John Edwards historically) avoid this 3.8% Medicare tax—and sometimes Social Security tax as well—by claiming that their labor income is instead pass-through business income that falls into one of these tax-exempt or tax-preferred buckets.

The different treatment of some pass-through business income from other economically identical types of such income is a classic example of transactional complexity. It creates traps for the unwary, enabling savvy taxpayers to avoid the tax by changing the legal form of their ownership or the payments they receive. Less savvy taxpayers, all wage earners, and all sole proprietors are left footing the bill.

Former President Obama's final budget proposed rationalizing these taxes so that all income above these thresholds was subject to the 3.8% tax either through the NIIT or SECA.[77] It also proposed treating eliminating differences in how professional services income is taxed depending on whether it is paid by an S corporation or partnership. Together, these proposals would raise $272 billion over 10 years. In addition, all NIIT revenue would be redirected from the General Fund to the Medicare trust fund, extending its solvency by more than 15 years.[78]

A second reform worth serious consideration is repealing stepped-up basis. Sometimes called the single biggest loophole in the individual income tax,[79] stepped-up basis refers to the fact that capital gains on assets held until death are never taxed—instead the tax on such gains is forgiven forever. Stepped-up basis creates a large incentive for investors to hold on to underperforming assets purely for tax reasons (the so-called lock-in effect), resulting in resources being misallocated throughout the economy. It also creates traps for the unwary who do not realize how

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[73] Tax Policy Center, "T16–0085—Number of Tax Units by Tax Bracket and Filing Status," Tax Policy Center (July 6, 2016), *http://www.taxpolicycenter.org/model-estimates/baseline-distribution-tax-units-tax-bracket-july-2016/t16-0085-number-tax-units-tax* (estimating that 79% of taxpayers are in the 15% bracket or below, and 95% are in the 25% bracket or below).

[74] Urban-Brookings Tax Policy Center Microsimulation Model, "T17–0162—Revenue Effect of Options for Taxing Pass-Through Income at Preferential Rates, Baseline: Current Law with Individual AMT Repealed and 12/25/33 Percent Individual Income Tax Rate Structure, 2018–27," Tax Policy Center (May 15, 2017), *http://www.taxpolicycenter.org/model-estimates/options-taxing-pass-through-income-prefential-rates-may-2017/t17-0162-revenue-effect;* Robert Schroeder, "Trump Proposal to Lower Pass-through Tax Rate Could Cost $2 Trillion, Goldman Finds," *MarketWatch* (May 3, 2017), *http://www.marketwatch.com/story/trump-proposal-to-lower-pass-through-tax-rate-could-cost-2-trillion-goldman-finds-2017-05-03.*

[75] Kyle Pomerleau, Scott Drenkard, and John Buhl, "What Trump Can Learn from Kansas' Tax Troubles," *Politico* (May 4, 2017), *http://www.politico.com/magazine/story/2017/05/04/what-trump-can-learn-from-kansas-tax-troubles-215103.*

[76] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," 169 (February 2016).

[77] *Id.*

[78] Office of Management and Budget, "Meeting Our Greatest Challenges: Opportunity for All" (2016), *https://obamawhitehouse.archives.gov/sites/default/files/omb/budget/fy2017/assets/opportunity.pdf.*

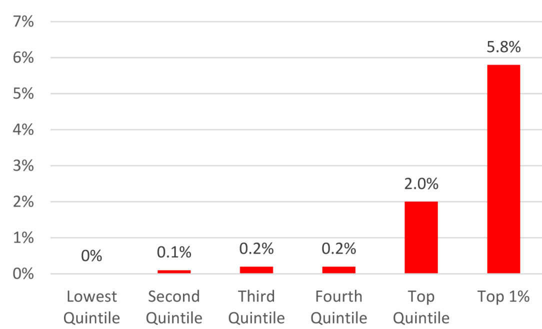
[79] *See, e.g.,* Len Burman, "President Obama Targets The 'Angel of Death' Capital Gains Tax Loophole," *Forbes* (January 18, 2015).

much tax they can save by holding on to their assets even if they are underperforming.

Former President Obama proposed repealing stepped-up basis subject to several exclusions, including an exemption for the first $100,000 in accrued gains ($200,000 per couple).[80] Together with raising the capital gains rate to 28 percent (an idea discussed next), this proposal would raise $210 billion over 10 years and significantly more over time as it fully phased in.[81] The proposal would also be extraordinarily progressive because inheritances are distributed so unequally and accrued gains are even more concentrated among the rich.[82] It would further help ensure that those who inherit large sums are taxed at a rate closer to those who earn their income from working. A full 99% of the revenue raised would come from the top 1%, and 80% would come from the top 0.1%.[83]

A third, related reform is narrowing the gap between the tax rates on ordinary income and capital gains. This gap creates a large incentive for taxpayers to try to recharacterize ordinary income as capital gain, with carried interest a prime example. In addition to treating carried interest as ordinary income to the extent that it represents compensation for services,[84] Congress should consider raising the capital gains rates to reduce this incentive in the first place.

Figure 11: Percent Change in After-Tax Income from Preferential Rates for Capital Gains and Dividends



Source: Tax Policy Center, *Table T17-0137* (Apr. 18, 2017).

Capital gains are highly concentrated among the wealthy. As a result, the preferential rates for capital gains and dividends very disproportionately benefit them. As illustrated in Figure 11, these preferential rates provide the top 1% with a tax cut that is 29 times larger than that for the middle quintile, even when measured as a share of after-tax income.[85] Indeed the top 0.1% of taxpayers, earning over $3 million per year, receive more than 55% of the benefits.[86] Raising these preferential rates could help curb rising economic inequality, making the tax code fairer. But it would also reduce transaction complexity by reducing one of the biggest incentives for tax planning in the income tax.

[80] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," 156, (February 2016). The proposal would also exempt all gains on the sale of tangible personal property, and would effectively establish a $500,000 per-couple exemption for gains on residences.

[81] *Id.*

[82] James Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," in *Rethinking Estate and Gift Taxation,* 439–40 (William G. Gale et al. eds., 2001). Untaxed accrued gains compose 36 percent of the value of all bequests, but 56 percent of bequests over $10 million.

[83] Executive Office of the President and U.S. Treasury Department, "The President's Plan to Help Middle-Class and Working Families Get Ahead," 35 (April 2015).

[84] Senator Baldwin and Representative Levin have introduced bills to address this issue. *See* S. 1020, 115th Congress (2017); H.R. 2889, 114th Congress (2015).

[85] Tax Policy Center, "Table T17–0137" (April 18, 2017), *http://www.taxpolicycenter.org/model-estimates/individual-income-tax-expenditures-april-2017/t17-0137-tax-benefit-preferential.*

[86] *Id.*

IV. INDIVIDUAL TAX REFORM SHOULD MAKE TAX INCENTIVES FAIRER AND MORE EFFICIENT

A final area on which individual tax reform should focus is reforming tax incentives to make them more efficient and fair. As just discussed, some tax provisions create opportunities for gaming that Congress did not intend. But many other tax provisions, which I will call tax incentives, are explicitly intended to change behavior, for example by encouraging people to attend college or purchase health insurance. In such cases, it is not a problem if people respond to the tax incentive; in fact, that is the whole purpose. But many such tax incentives are poorly designed to achieve their own goals. Restructuring them to get more bang-for-the-buck could simultaneously improve social outcomes and raise revenue, which could be used to reduce our mounting debt, address rising inequality, and broaden opportunity. One could spend a whole hearing on each individual tax incentive, so I will instead highlight a few general principles and case studies here.

First, the most efficient type of tax incentive is generally a refundable tax credit. As Fred Goldberg, Peter Orszag, and I have explained, deductions can be efficient if they are designed to measure income or ability to pay.[87] Deductions for business expenses are one such example. But where, as with tax incentives, the goal is to promote socially valued activities or investments, the most efficient default structure is a uniform incentive—unless there is evidence that certain households are more responsive to the incentive or generate larger social benefits from engaging in the activity. Such uniform benefits can only be accomplished through a refundable tax credit.

Even when there is evidence that responsiveness or social benefits vary by household income or other characteristics, the most efficient incentive is almost certainly still some type of refundable credit. It is extremely unlikely that there is a sharp break in social benefits or responsiveness to a tax incentive exactly at the point of no income tax liability or the rate bracket thresholds. But these types of discontinuities are inherent in all other types of tax incentives. For example, preferential rates and non-refundable credits do not benefit taxpayers in the zero bracket, while the value of above-the-line deductions and exclusions intrinsically rises with the taxpayer's marginal tax rate.

Congress should therefore consider restructuring all tax expenditures that are intended to change behavior into refundable tax credits, designing them based on evidence of how to get the most bang for the buck. In all likelihood, this will also make the tax code more progressive. Even if, for example, higher-income households are more responsive to a tax incentive, it is unlikely that the optimal tax incentive will be as regressive as many of the deductions, exclusions, and preferential rates that we have today. Restructuring tax incentives into refundable tax credits will, however, be a major undertaking. Currently, only about 12% of tax expenditures are structured as refundable credits, as illustrated in Figure 12.

Second, wherever possible, Congress should leverage the insights of behavioral economics when redesigning tax incentives. Doing so can also generate more social benefits at a lower cost.

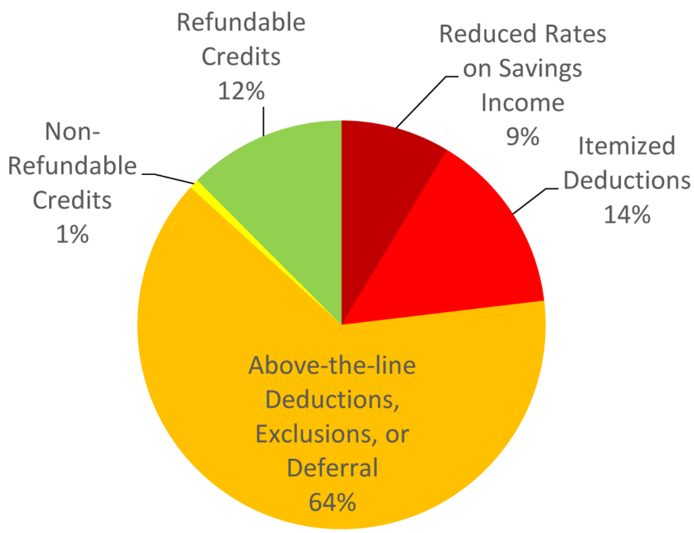
To provide one example, tax incentives for retirement savings are a particularly fruitful area for reform. Though we currently spend more than $80 billion per year on retirement savings incentives, the median household nearing retirement has only $14,500 in retirement savings.[88] About one-third of workers do not have access to an employer-sponsored retirement plan, even though middle-class workers are 15 times more likely to save for retirement if they are covered by an employer plan.[89]

[87] Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stanford Law Review* 23 (2006).

[88] Keith Miller et al., "The Reality of the Retirement Savings Crisis," Center for American Progress (January 26, 2015) (figure is for households age 55 to 64, and excludes Social Security).

[89] "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy," hearing before the Sentate Committee on Finance, 113th Congress 9–10 (2014) (statement of Scott Betts, senior vice president of national benefits services, LLC).

Figure 12: Share of Cost of Tax Expenditures by Form, 2016



Source: Author's calculations based on OMB, Analytic Perspectives FY2017, tbl. 14-2, Year 2016 (2016).

Low- and middle-income families are generally the least prepared for retirement,[90] but the lion's share of tax incentives for retirement savings go to the wealthy. Households in the top income quintile receive two-third of the benefit of retirement savings incentives and those in the top 5% receive more than one-third of the benefits.[91] In contrast, the bottom two quintiles only receive 7% of the benefits.

In addition, there is extensive empirical evidence that retirement savings choices are heavily influenced by how easy it is to save principally as a result of defaults. For example, new hires are about 50 percentage points more likely to participate in their employer's retirement plan if they are automatically enrolled.[92] There have been several positive reforms in response to this research. For example, the Pension Protection Act of 2006 and Treasury Department guidance issued before and after it contributed to a large rise in automatic enrollment.[93] But the default retirement savings rate is still zero for roughly 62% of workers, as illustrated in Figure 13.

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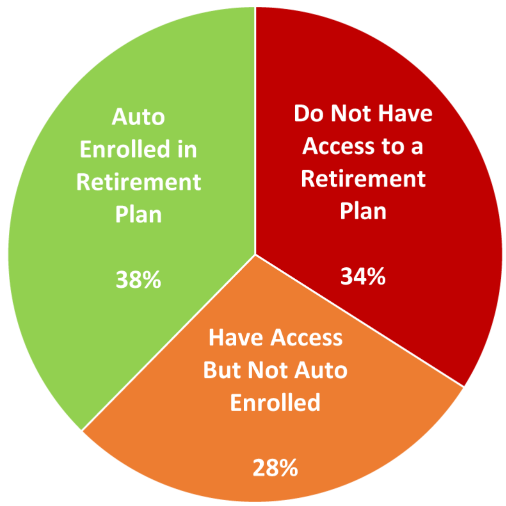
[90] Alicia Munnell et al., "NRRI Update Shows Half Still Falling Short" (Center for Retirement Research Brief No. 14–20, December 2014).

[91] Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," table 2 (May, 2013).

[92] Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," 116 *Quarterly Journal of Economics* 1149 (2001). While many of these workers would eventually join the plan if enrollment were voluntary, accelerating participation through auto-enrollment substantially boosts the overall retirement savings of most workers.

[93] In 2014, 57% of 401(k) plans auto-enrolled their workers compared to less than 10% in 2000. Plan Sponsor Council of America, 58th Annual Survey (2016).

Figure 13: Share of Workers with Default to Save for Retirement



Source: Author's calculations based on PLAN SPONSOR COUNCIL OF AMERICA, 58TH ANNUAL SURVEY (2016); BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY, tbl.2 (2016).

As part of individual tax reform, Congress should therefore consider a number of ways to improve retirement savings incentives. These include restructuring the tax incentives so that a larger share of the benefits go to low- and middle-income workers,[94] directly depositing the incentive into the taxpayer's account,[95] requiring employers offering retirement plans to automatically enroll their workers, and enacting automatic IRAs at a Federal level so that every worker has access to an easy way to save for retirement.[96] Such reforms could substantially boost retirement security while saving revenue. Automatic IRAs alone would give 30 million more workers access to a workplace savings opportunity.[97]

To provide another example, many would argue that the purpose of the tax exemption for State and local bonds is to support investments by State and local governments, effectively devolving Federal revenue to them. But about 20% of the value of the exemption goes to high-bracket investors in the form of above-market after-tax interest rates, rather than to State and local governments in the form of lower

[94] *See, e.g.,* William G. Gale et al., "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (The Hamilton Project, Discussion Paper 2006–02, 2006), *https://www.brookings.edu/wp-content/uploads/2016/06/200604hamilton_2.pdf;* Christian E. Weller and Sam Ungar, "The Universal Savings Credit" (Center for American Progress, July 2012), *https://cdn.americanprogress.org/wp-content/uploads/2013/07/UniversalSavingsCredit-report.pdf.*

[95] Emmanuel Saez, "Details Matter: The Impact of Presentation and Information on the Take-up of Financial Incentives for Retirement Saving," 1 *American Economic Journal: Economic Policy* 204 (2009).

[96] Senator Whitehouse and Representative Neal have introduced Federal automatic IRA legislation, S. 245, 114th Congress (2015); H.R. 2499, 115th Congress (2017). For more details on auto-IRA proposals, *see, e.g.,* Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," The Retirement Security Project (2009), *http://www.brookings.edu/research/papers/2009/07/automatic-ira-iwry;* Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals," 134, (February 2015).

[97] Executive Office of the President and U.S. Treasury Department, "The President's Plan to Help Middle-Class and Working Families Get Ahead," 5 (April 2015).

interest costs.[98] If Congress replaced the exemption with a refundable tax credit, as was the case with Build America Bonds, we could deliver the same amount of aid to State and local governments at a much lower budgetary cost.

QUESTIONS SUBMITTED FOR THE RECORD TO LILY L. BATCHELDER

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

INCREASING THE STANDARD DEDUCTION

Question. Ms. Batchelder, in your written testimony, you are critical of Republican proposals to nearly double the standard deduction.

But for the sake of fairness and transparency, can you please acknowledge that the ranking member has repeatedly proposed nearly *tripling* the standard deduction?

Answer. Yes, the ranking member has proposed nearly tripling the standard deduction. However, he did so in the context of tax plans that were roughly revenue-neutral and somewhat more progressive compared to current policy at the time, unlike the plans put forth by President Trump or the TCJA as enacted.[1] Moreover, my criticism of increasing the standard deduction was in the context of arguing that tax reform should increase taxes on the wealthy and use some of the revenues raised for deficit reduction and some to boost the take-home pay of those who are less fortunate. To the extent that increasing the standard deduction was coupled with other reforms that together achieve these overall objectives, I would be less concerned.

ASSUMPTIONS ASSOCIATED WITH THE PRESIDENT'S AND THE HOUSE'S TAX PLANS

Question. Ms. Batchelder, your testimony provides a detailed, and negative, assessment of tax "plans" offered by President Trump and the House GOP leadership. Given the level of generality of what has been put forward for each of those so-called plans, it is impossible to provide the level of details about the implications of the plans unless, as you have done, you fill in details with your own assumptions.

My question is, are the negative implications that you have often discussed of the so-called plans put forward by the President and the House GOP actually an analysis of detailed specified plans, or are they implications of assumptions that you made that aren't specified in any detailed plan?

That is, are they results from a detailed plan, or the results of your individual interpretation of what a plan is going to look like once details are finished?

Answer. Any analysis of tax reform proposals prior to enactment (and even, to some degree, after enactment) requires assumptions about how details will be filled in. Unless we are going to avoid discussing the potential impact of tax reform plans altogether, some assumptions are necessary.

In my view, tax experts both inside and outside government should try to educate the public about the potential impact of tax reform proposals, and, when they do so, they should make reasonable assumptions about how the details will be filled in and clearly state those assumptions. The portions of my written testimony that are critical of the President's and House GOP's proposals rely upon estimates by independent, nonpartisan organizations that I think easily meet these standards.

PROGRESSIVITY V. EFFICIENCY

Question. Ms. Batchelder, in the hearing you stated:

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[98] Congressional Budget Office and Joint Committee on Taxation, "Subsidizing Infrastructure Investment With Tax-Preferred Bonds," 34 (October 2009). CBO and JCT estimate that State and local governments are able to pay interest at a rate that is 21% below that of comparable taxable bonds because of the exemption. This implies that investors in tax brackets above 21% benefit from the exemption by an amount equal to their marginal tax rate minus 21% multiplied by the amount of tax-exempt interest they receive. *Id.* at 31–33.

[1] Jim Nunns and Jeffrey Rohaly, "Preliminary Revenue Estimates and Distributional Analysis of the Tax Provisions in the Bipartisan Tax Fairness and Simplification Act of 2010," Tax Policy Center, 2010, *http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/412098-Preliminary-Revenue-Estimates-and-Distributional-Analysis-of-the-Tax-Provisions-in-the-Bipartisan-Tax-Fairness-and-Simplification-Act-of--.PDF.*

> Well, I certainly think there is a point where the tax code can be too progressive or too targeted on just one, or a handful of individuals. But I think we are very far from that point. We have very vastly rising inequality in this country and the tax code could do a lot more to help mitigate that. So I don't think that anything that is on the potential drawing room table right now is at risk of making the tax code too progressive. But I'm sure that if you purposed replacing the entire income tax system with only taxing Bill Gates, I would think that is both unfair and inefficient.

That's a reasonable enough statement, but could you flesh that out more please?

At what point would the tax code be too progressive? Would the code be too progressive if it taxed only the wealthiest 1 percent?

Were the individual income tax rates at the time of the Truman Presidency too progressive?

At what point would you think a tax was so progressive that it constituted a takings, within the meaning of the Fifth Amendment to the Constitution?

Are the goals of efficiency and progressivity in tension with each other? If Congress could significantly increase GDP, but that would make the code slightly less progressive, would you say that is an unacceptable bargain? Should we be willing to take a hit to growth, if it significantly increased progressivity?

Do you think it an important check on the voting public's appetite for larger government expenditures that all of the voting public somewhat directly pays for some of those expenditures?

I realize that these are not easy questions, but since you have emphasized the important issue of progressivity in the tax code, it seems fair to ask them of you.

Answer. At the beginning of the Truman Presidency, the top individual statutory income tax rate was 94%. I do think that is too high. However, what really matters are average tax rates and effective marginal tax rates, not the statutory tax rate. For example, if the top statutory tax rate were 94% but every taxpayer automatically could deduct 75% of their income, the top effective marginal tax rate would only be 23.5% and the top average tax rate is even lower (assuming a progressive rate schedule). I am not an expert on the tax code during the Truman Presidency so I do not know what the top average tax rate and top effective marginal tax rate were at the time.

I am also not a constitutional law expert so I cannot advise on the point at which a tax is so progressive that it constitutes a taking under the Fifth Amendment. To my knowledge, the Federal income tax under the Truman Presidency was not successfully challenged as a taking, so that seems to indicate that tax rates could be substantially higher than they are now without violating the Takings Clause.

The goals of efficiency and progressivity are sometimes in tension with each other and sometimes are not. It depends in part on whether the policy in question is addressing what economists would call a market failure, such as negative externalities or market power.

In my view, GDP is a relatively poor measure of how well-off Americans are, and policymakers should adopt more refined objectives for fiscal policy than simply maximizing GDP. Personally, I would be more interested in measures that place relatively more weight on $1 in additional income earned by the middle class and those who are less fortunate than $1 in additional income for a billionaire. In certain circumstances, I would view policies that slightly reduce GDP but make the Code substantially more progressive as worth serious consideration. For example, if a tax proposal would reduce GDP by $0.1 billion but that was the product of a $1 billion increase in the collective income of middle-class workers and a $1.1 billion decrease in the income of the single wealthiest American, I would consider that a reasonable approach.

I am not sure I follow your question about whether it is an important check on the voting public's appetite for larger government expenditures that all of the voting public somewhat directly pays for some of those expenditures. However, I do not think it is necessary or important for every American to pay some tax in order for them to exercise their right to vote responsibly. Many voters—rich, poor, and middle class—vote against their economic self-interest when they think a different approach is better for the country. We all contribute to and benefit from our government in myriad ways. But even if one did think it was important for all voters to pay some tax, I would note that all income groups on average pay positive federal taxes in a given year,[2] a relatively small share of households (many of whom are elderly or disabled) do not pay positive federal taxes in any given year, and that share becomes even smaller if one looks over multiple years and/or includes state and local taxes.

CAPITAL GAINS VERSUS ORDINARY INCOME

Question. Ms. Batchelder, you mention how the gap between the capital gains tax rate and the higher ordinary income tax rate creates a large incentive for taxpayers to try to re-characterize ordinary income as capital gains. She proposes addressing this problem by "raising the capital gains rates to reduce this incentive."

But, to be clear, one equally effective way to address this problem is to reduce the ordinary income tax rates, right?

Answer. Yes, reducing ordinary income tax rates while holding constant capital gains rates would reduce the incentive for taxpayers to re-characterize ordinary income as capital gains. I have other concerns with this approach; namely, that it would worsen budget deficits and make the tax code less progressive.

HIGH IMPLICIT MARGINAL TAX RATES

Question. Ms. Batchelder, you wrote something I really appreciated. You wrote: "Low-income workers face some of the highest implicit marginal tax rates."

I think you're right, and it's a serious problem. But later in your testimony, you talk positively about a proposal from a member of this Committee to increase the Earned Income Tax Credit and you note that the proposal would phase the EITC out more rapidly.

But wouldn't a more rapid phase-out of the EITC increase the highest implicit marginal tax rate of those low income workers in the phase-out range?

Answer. Any increase in the EITC that holds constant the current phase-in and phase-out income thresholds will result in lower implicit marginal tax rates in the phase-in range and higher implicit marginal tax rates in the phase-out range, compared to current law. An extensive body of research finds that EITC expansions on net increase labor force participation despite these somewhat offsetting incentives.[3] These effects appear to be due in part to many individuals making decisions about working more at the "extensive margin" rather than the "intensive margin." In other words, many individuals look more at what their after-tax return is to working overall, rather than their after-tax return to an additional hour of work. Because any EITC expansion necessarily increases the after-tax return to working overall, it will increase incentives to engage in market work at the extensive margin. To the extent that individuals do make incentives about working at the intensive margin, they appear to respond more to the EITC's phase-in incentives than its phase-out incentives. For example, a recent study found that responsiveness to the EITC's phase-in incentives is two to six times stronger than responsiveness to its phase-out incentives.[4]

The research to date therefore strongly suggests that EITC expansion proposals like those discussed in my written testimony will *increase* labor force participation overall, even though they result in higher implicit marginal tax rates over some income ranges.

QUESTION SUBMITTED BY HON. MIKE CRAPO

Question. Ms. Batchelder, I would like to explore what I see as a potentially under-reported challenge we may face in developing comprehensive tax reform. This came to mind after reviewing a recent hearing this committee held regarding the nationwide shortage of affordable housing. The hearing discussed important matters

[2] *See, e.g.,* Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2013," June, 2016, *https://www.cbo.gov/publication/51361.*

[3] *See e.g.,* Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income Among Female-Headed Families," *Review of Economics and Statistics,* 2003; and Jeffrey Liebman and Nadda Eissa, "Labor Supply Responses to the Earned Income Tax Credit," *Quarterly Journal of Economics,* 1996.

[4] Raj Chetty, John N. Friedman, and Emmanuel Saez, "Using Differences in Knowledge Across Neighborhoods to Uncover the Impacts of the EITC on Earnings," *American Economic Review,* 2013, *http://www.nber.org/papers/w18232.pdf.*

like the Low-Income Housing Tax Credit or LIHTC. I am a longtime supporter of LIHTC, as are a number of my colleagues, and the hearing explored bipartisan proposals to expand the credit. What hasn't received much attention, though, is how LIHTC actually works. It is not a tax credit, as some may think, that goes to the seniors and low-income families that live in these affordable-housing units. Is it not correct that the actual tax credits flow to banks and typically wealthy investors, allowing them to offset about $9 billion of their annual income that would otherwise be taxable?

In exchange, these banks and investors put their own capital toward these affordable housing units, which, without these investments, would not be able to be rented out at rates low enough to be affordable for low income families.

This brings me to some of the public lines in the sand being drawn by some, including some of my colleagues, stating that tax reform must not in any way reduce taxes for those above certain income thresholds. If that is the standard, would it not be accurate to say that this would mean that proposals such as the Cantwell-Hatch bill to expand the Low-Income Housing Tax Credit, would be considered off the table for tax reform, because, regardless of what other important economic and policy benefits the credit provides to low income renters, it most certainly also provides a significant reduction in taxes for banks and upper income investors?

Wouldn't a similar standard also apply to a theoretical proposal to make permanent the New Markets Tax Credit, which is otherwise set to expire in a couple years? While New Markets has strong bipartisan support, and certainly provides important economic and public policy benefits to rural and low income communities, is it not also the case that the actual tax credits are typically claimed by banks and upper-income investors, which would mean an extension of the New Markets Tax Credit would also violate standards we have heard about, like the Mnuchin Rule, or the "Not One Penny" standard?

And really, aren't there many other broadly supported tax provisions that provide important public policy and economic benefits, which might also be candidates for attention in tax reform, that would have to be taken off the table if we are subject to strict standards on who can and cannot receive any benefits through the tax code from tax reform, like municipal bonds or conservation easements or many other provisions?

Based on these facts, would you agree that it would not be appropriate or productive to set up a standard for evaluating tax reform that cherry picks data to try to support one's position? For example, it would not be appropriate, in the context of a full comprehensive reform package, to evaluate some provisions solely by how they change particular tax rates for particular taxpayers, or how they change after-tax income for particular taxpayers, but then do not fully account for the broader secondary economic effects and effects on meeting important public policy goals (which are not always easily quantifiable). Conversely, it would then also not be appropriate to cherry pick and evaluate other provisions in that same comprehensive bill only by their broader economic and public policy effects, but not take into account how those policies effect tax rates or after tax income, correct?

In order to best serve the American people and get the best tax policy for everyone, would it not be best to set evaluation standards that are comprehensive, and take into account not only the changes in rates and tax effects on taxpayers, but also a full evaluation of the broader secondary effects on the economy and on meeting public policy goals?

Answer. In light of mounting inequality and deficits, I agree with statements that tax reform should not provide a net tax cut to the wealthy. However, your question raises several important issues about what this means.

First, by "net" I mean that we should look at whether tax reform proposals provide a tax cut to the wealthy after accounting for all of the provisions in any bill. Any major tax reform will entail many moving pieces. I do not find it objectionable if some provisions cut taxes for the wealthy so long as they are more than counterbalanced by other provisions that ask them to contribute more.

Second, a fundamental tenet of economic analysis of taxes is that the person who nominally remits a tax (or nominally claims a tax benefit) is not necessarily the person who bears the burden or "incidence" of the tax (or reaps the benefit of a tax expenditure). For example, there is broad consensus that the employer share of the payroll tax is borne by employees even though it is nominally paid by the employer. This is relevant to your question about the LIHTC. I am not sure how JCT distributes the benefit, but it would make sense to me if they partially distributed it to tenants in LIHTC developments and partially to the developers and investors. Regardless, when considering whether a tax reform plan cuts taxes for the wealthy on net, I believe we should look at the economic incidence of the plan, not at how it changes who nominally remits taxes or claims tax expenditures.

This raises a third question: what authority should policymakers rely upon when considering the economic incidence of a tax reform proposal? My answer is, where at all possible, the Joint Committee on Taxation. They are the official nonpartisan estimators for Congress and have an exceptional staff and track record. While many have quibbles with certain aspects of their estimates, myself included, they are the independent referee and should be respected as such. Moreover, JCT meets the standards I outlined above: they do distribute taxes and tax expenditures (like LIHTC and the NMTC) according to who they believe bears the economic incidence, not to the person who nominally remits the tax or claims the tax expenditure.

JCT of course has incredible demands upon its time and a small staff. It is therefore not able to provide as many estimates of the revenue, distributional and other impacts of tax proposals as members of Congress and the public might like. When their estimates are not yet available, I think it is reasonable to rely upon estimates by independent, nonpartisan organizations like the Tax Policy Center that attempt to replicate the JCT's methodological approach, adopt reasonable assumptions where policy details are unspecified, and are transparent about what assumptions they adopt.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. In your opinion, did the 1986 Tax Reform Act solve the problems it was intended to fix? If so, please provide some examples of how. If not, why?

Answer. One could write a book in response to this question (and some have!). To answer briefly, though the 1986 Tax Reform Act certainly was not perfect, I do think it made substantial headway in addressing some problems it was intended to fix.

One example is the passive loss rules. Individual tax shelters were a huge problem prior to the 1986 Act. They typically involved relatively well-off taxpayers purchasing overpriced assets financed with seller-issued non-recourse debt in order to defer paying tax on their labor income and convert it into capital income eligible for preferential rates. The passive loss rules dramatically reduced the incentives for individuals to engage in such tax shelters and, as a result, they largely disappeared.

Question. If you can, please provide some suggestions on how the President could achieve some of his stated objectives for tax reform, including (1) reducing complexity in the tax code and hours spent on tax-related paperwork, (2) making the tax code fairer, (3) raising wages, (4) sustaining 3 percent economic growth or higher, and (5) imposing a "price to pay" for companies that offshore jobs.

Answer. As discussed in my written testimony, some proposals that I think would achieve several of these objectives at once include:

- Expanding the Earned Income Tax Credit (EITC) for all workers, but especially for those without dependents.
- Increasing refundability of the child tax credit (CTC), especially for families with young children.
- Replacing the current law child and dependent care tax benefits with a single refundable tax credit that is larger for families for whom such expenses represent the largest budgetary strain.
- Strengthening wealth transfer taxes.

Question. How would you suggest Congress address the problem of wealthy taxpayers using secret, private letter rulings from the IRS to gain tax advantages not explicitly intended by Congress?

Answer. As far as I know, private letter rulings have been publicly available since the D.C. Circuit ruled in 1974 that they had to be disclosed (in redacted form) under

FOIA.[5] But if you are referring to a different kind of agreement between the IRS and taxpayers, I am happy to respond.

Question. How would you suggest Congress address the skyrocketing cost of rental housing? Please provide some ideas to consider.

Answer. Generally, I think the best way to increase housing affordability is to boost the take-home pay of workers, rather than provide subsidies that are limited to housing and therefore place a thumb on the scale in favor of some kinds of consumption over others. The proposals I outlined in my written testimony—such as expanding the EITC and increasing refundability of the CTC—would indirectly make rental housing more affordable for those who are struggling the most.

Some other ideas Congress should consider are fully funding housing choice vouchers (section 8) and expanding LIHTC.

PREPARED STATEMENT OF ALEX M. BRILL, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Chairman Hatch, Ranking Member Wyden, and other members of the committee, thank you for the opportunity to testify this morning. My name is Alex Brill, and I am a resident fellow at the American Enterprise Institute, a public policy think tank here in Washington, DC. I commend the committee for holding this important and timely hearing. The views and opinions I offer today are mine alone and do not represent those of my employer or necessarily those of my colleagues at AEI.

The opportunity for fundamental and comprehensive tax reform is before this committee for the first time in many decades. As every member of this committee well knows, the tax code has frequently and sometimes significantly changed over the last 30 years, but not since 1986 has it been truly reformed in a manner that sought to broaden the base—that is, eliminate special deductions, credits, and exclusions—while lowering statutory tax rates. As Senators Hatch, Wyden, Roberts, and Grassley know firsthand, that legislative process was arduous and sometimes controversial, but the 1986 Tax Reform Act did result in a simpler income tax code with a broader tax base and significantly lower statutory tax rates.

The last 30 years have seen tax complexity increase dramatically with the introduction of more and more tax expenditures. In many regards, the tax code today imposes undue and unnecessary burdens on taxpayers. Complexity and compliance costs are significant. High effective marginal tax rates impede investment,[1] discourage savings,[2] and encourage taxpayers to reduce their reported taxable income.[3] Moreover, the myriad of tax expenditures in the tax code today yields wide disparities in tax burdens among taxpayers with similar amounts of income.

Reversing the trend of the last three decades and pursuing an individual income tax reform that relies on a broader and fairer tax base will facilitate a move toward lower statutory rates and a more efficient and simpler tax code. A more neutral tax code will facilitate a more productive allocation of resources and can contribute to a pro-growth economic environment.

In my testimony today, I would like to discuss 5 points:

1. The current individual income tax system is complex, burdensome, and riddled with deductions, exclusions, and credits. Broadening the tax base can be a meaningful tax simplification.
2. The current individual income tax system treats taxpayers with similar amounts of income very differently. Broadening the tax base is an effective

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[5] *Tax Analysts and Advocates vs. IRS,* 362 F. Supp. 1289 (D.C.D.Ct. 1973), modified 505 F.2d 350 494 (D.C. Cir.1974).

[1] *See,* for example, Kevin A. Hassett and R. Glenn Hubbard, "Tax Policy and Business Investment," in *Handbook of Public Economics, Volume 3,* ed. Alan J. Auerbach and Martin Feldstein (Amsterdam: North Holland Publishing Co., 2002), 1,293–1,343.

[2] *See,* for example, Alan D. Viard, "Capital Income Taxation: Reframing the Debate," AEI *Economic Perspectives,* July 2013, available at *www.aei.org/wp-content/uploads/2013/07/-capital-income-taxation-reframing-the-debate_172019152543.pdf.*

[3] *See,* for example, Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review," *Journal of Economic Literature* 50, no. 1 (2012): 3–50, available at *http://darp.lse.ac.uk/papersdb/Saez_etal_(JEL12).pdf;* and Sarah Burns and James Ziliak, "Identifying the Elasticity of Taxable Income," *The Economic Journal* 127, no. 600 (March 2017): 297–329.

means for correcting this disparity and reducing horizontal inequity in the tax code.

3. In addition to contributing to complexity and horizontal inequity, itemized deductions are generally regressive tax policies. The deduction for State and local taxes is an excellent example of this and is a policy that, ironically, incentivizes States to pursue more progressive (but inefficient) tax policies.
4. Broadening the tax base, particularly with regard to limiting itemized deductions, is an opportunity to move toward a more neutral tax code and a more level playing field economically.
5. The transitionary path from the tax code we have today to a fairer, simpler, and more pro-growth tax system is itself a complex challenge that will require lawmakers to strike a careful balance. Inadequate or insufficient transition relief may cause some taxpayers to face steep, unanticipated tax burdens judged unfair by policymakers. Conversely, overly extended transition relief (for example, repeal of an ineffective tax credit beginning 10 years hence) may severely limit the potential economic gains from tax reform.

1. COMPLEXITY IN THE TAX CODE ABOUNDS

Members of this committee know well the complexity of the current tax code. The IRS Taxpayer Advocate estimates that nearly 2 billion hours are spent preparing Form 1040 every year. Various Form 1098s, 1099s, and 5498s, which relate to reporting mortgage interest expense, dividends and interest income, and distribution of pensions, among other activities, total over 700 million additional hours annually. Collectively, this 2.7 billion hours is equivalent to over 1.3 million full-time workers.[4] Taxpayers employ a variety of strategies to comply with tax-filing obligations. Based on data from *IRS Compliance Data Warehouse,* about 40 percent of individual taxpayers use software to help them prepare their returns. These services can offer valuable convenience and save time but may cost taxpayers $3 billion annually.[5]

This complexity is not related to the statutory rate (or number of rates) at which the government taxes incomes but rather is primarily related to the elements of the tax code that alter taxpayer's tax liabilities, whether by permitting a deduction, an exclusion, or a credit. The Joint Committee on Taxation (JCT) identifies more than 250 such tax expenditures in the Internal Revenue Code,[6] though there is no definitive methodology for constructing this list and many of these provisions do not relate directly to individuals. Moreover, surtaxes such as the Alternative Minimum Tax are another clear source of complexity.

One indicator of the complexity of the tax code can be observed by analyzing the number of taxpayers who itemize their deductions as opposed to claiming the standard deduction. According to recently released statistics from the IRS Statistics of Income (SOI), 150.6 million individual income tax returns were filed in tax year 2015, the most recent year for which these statistics are available. Of these, 44.5 million returns claimed a total of $1.2 trillion in itemized deductions. Mortgage interest deductions were claimed by 32.7 million taxpayers and totaled $279 billion. Charitable deductions were claimed on 36.6 million returns and totaled $201 billion. State and local income tax deductions (including the general sales tax deduction) were claimed on 42.6 million returns and totaled $338 billion.

More than one-fourth of all itemized deductions are claimed by fewer than 3 percent of taxpayers—those with adjusted gross incomes (AGIs) greater than $250,000. However, because these higher-income taxpayers face higher marginal tax rates, the tax savings they receive from these deductions is far greater than half of the total tax savings associated with these policies. Table 1 summarizes the distribution of itemized deductions as reported by the IRS for tax year 2015, while Figure 1 illus-

[4] *See* Figure 2.1.2 from the National Taxpayer Advocate's 2016 Annual Report to Congress, available at *www.taxpayeradvocate.irs.gov/reports/2016-annual-report-to-congress/full-report.* Total estimated preparation time for all forms is 6 billion hours annually. Because this hearing focuses on individual income tax, compliance costs related to business tax (corporate, partnership, and S corportions), estate and gift tax, excise tax, and taxation of foreign persons' U.S. source income are excluded.

[5] According to the National Taxpayer Advocate's 2016 Annual Report to Congress, the average cost of tax prep software is about $50. With 40 percent of the approximately 150 million individual returns completed using software (or 60 million tax returns), the estimated cost is $3 billion.

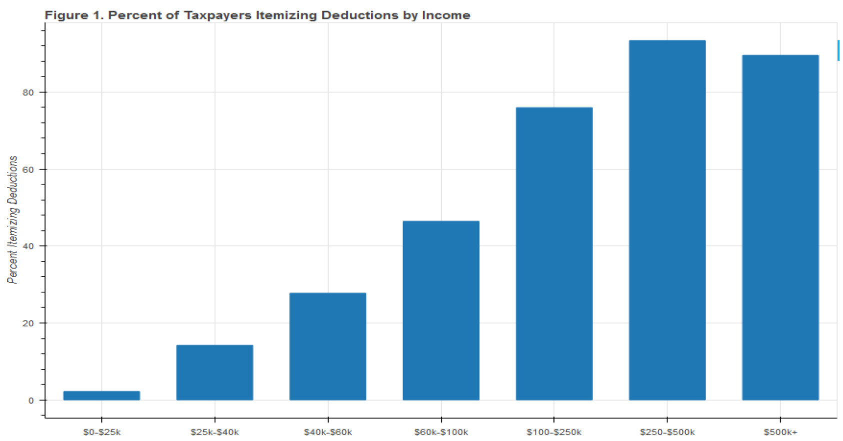
[6] Joint Committee on Taxation (JCT), "Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020," JCX–3–17, January 30, 2017.

trates this distribution visually using data and modeling made available by the Open Source Policy Center (OSPC) Tax-Calculator.[7] In brief, one-fifth of taxpayers earning near the median income are burdened with the complexity of itemized deductions. Over three-fourths of taxpayers with AGIs between $100,000 and $200,000 are itemizers, and nearly all taxpayers with AGIs greater than $200,000 itemize their deductions.

Table 1. Itemized Deductions by Adjusted Gross Income in Tax Year 2015

	Total	Under $15,000	$15,000 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 or more
Number of returns	150,565,918	35,584,745	30,103,270	26,564,740	32,892,457	18,634,133	6,786,573
Itemized deductions	44,477,185	1,323,310	2,785,803	5,485,481	14,438,234	14,101,283	6,343,076
Share itemizing	29.5%	3.7%	9.3%	20.6%	43.9%	75.7%	93.5%

Source: IRS SOI Bulletin.



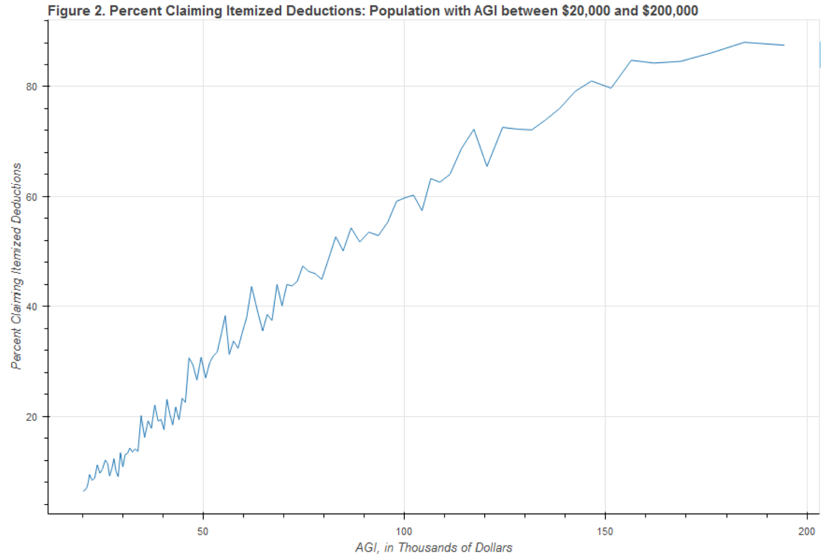
Source: Open Source Policy Center (OSPC).

Figure 2 narrows in on those taxpayers with AGIs between $20,000 and $200,000 and looks across this income spectrum in a more granular manner, making evident a clear and dramatic trend: as incomes rise, so does the tax code's complexity.

Other factors in addition to itemized deductions also contribute to the complexity of the tax code for individuals. In tax year 2015, 49.4 million taxpayers claimed one or more tax credits, including 22.6 million who claimed the child tax credit, 9.7 million who claimed an education tax credit, 2.7 million who claimed a residential energy credit, and 28.4 million who claimed the earned income tax credit (EITC).

[7] The Tax-Calculator is part of the Open Source Policy Center's (OSPC) TaxBrain modeling suite. More information about TaxBrain and the OSPC generally can be found at *www.ospc.org*. The entire suite of models, including source code, is publicly available.

Figure 2. Percent Claiming Itemized Deductions: Population with AGI between $20,000 and $200,000



Source: OSPC.

These credits and deductions reduce tax liabilities for targeted populations and can incentivize or reward particular behaviors or offer tax relief for taxpayers in certain circumstances. The merits and efficiency of various credits and deductions can be debated, but they generally add to the complexity of the tax code. Further complicating the tax code and leading to higher effective marginal tax rates is the phase out of various credits. For example, the JCT reports that 3.5 million households are subject to the phase out of the child tax credit. As a result, these taxpayers face marginal tax rates 5 percentage points higher.[8]

2. THE INDIVIDUAL INCOME TAX BREEDS HORIZONTAL INEQUITY

In addition to adding to the complexity of the tax code, a second consequence of the myriad of tax expenditures available to individual taxpayers is an increase in *horizontal inequity*—that is, similarly situated taxpayers paying dissimilar amounts of Federal income tax. In the most general terms, similar taxpayers may be considered two taxpayers with similar amounts of income. An alternative approach would be to consider both income and household size, recognizing the established principle in the U.S. tax code that, all else equal, larger households should pay less tax.

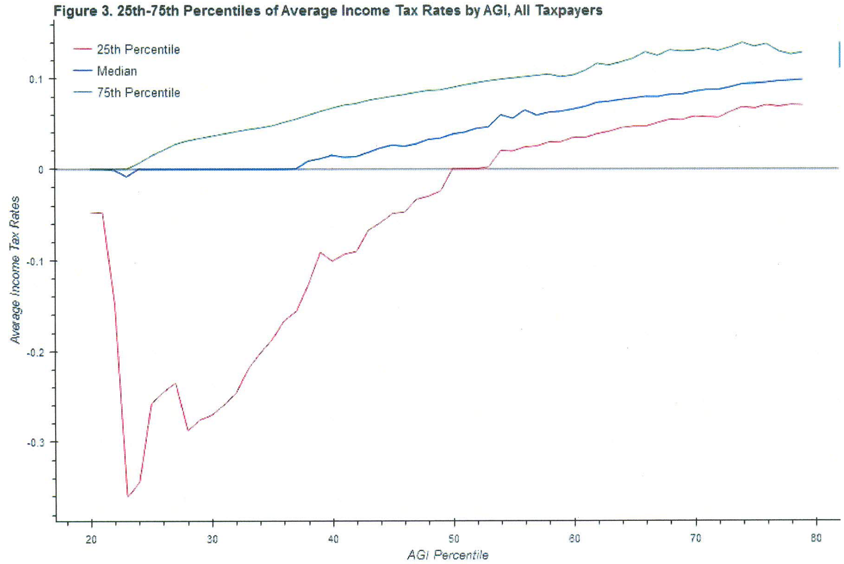
Consider, for example, two neighbors. Neighbor A owns her home, and Neighbor B rents. Neighbor A donates a significant amount of her income to charity. Neighbor B donates a significant amount of his time to a local charity. Neighbor A lives in Bristol, VA, and Neighbor B lives down the street in Bristol, TN. Even if these two taxpayers had identical incomes of $100,000, their Federal tax liabilities would differ considerably. Neighbor B would likely claim the standard deduction, but Neighbor A would likely deduct her mortgage interest costs, her charitable giving, and the income taxes she paid to the Commonwealth of Virginia. Moreover, if Neighbor A has a 17 year child, and Neighbor B has an 18 year old child, their income tax liabilities would be even more disparate.

To better understand this variance in tax liability among taxpayers with similar incomes, Figure 3 illustrates the disparity in tax liabilities among taxpayers within the same AGI percentile. For example, at the 70th AGI percentile, the median taxpayer within that group faces an average tax rate of 8 percent, while a quarter of those taxpayers pay 4 percent of their AGI or less and another quarter pay 13 percent or more. Figure 4 repeats this analysis but only for taxpayers with a constant

[8] JCT, "The Taxation of Individuals and Families," JCX–41–17, September 12, 2017.

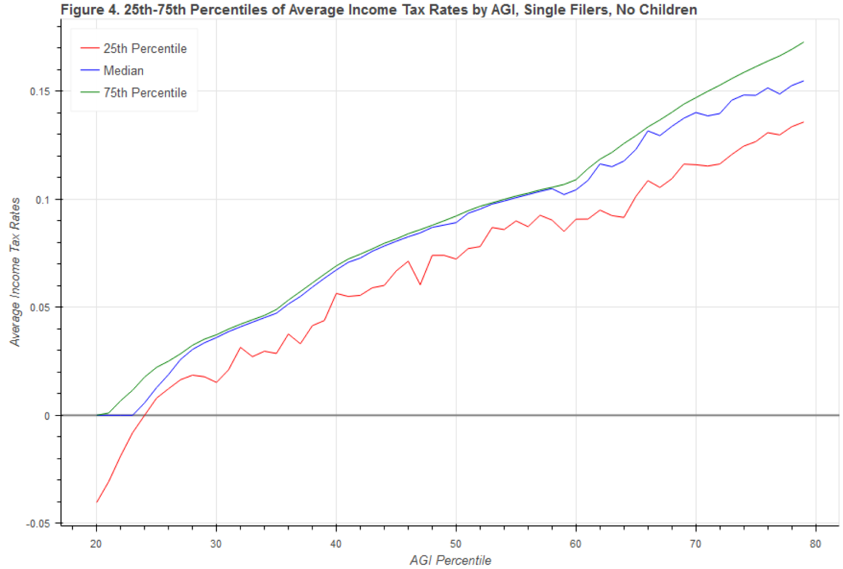
household size, single filers with no children. The disparity within percentiles is much less but still present.

Figure 3. 25th-75th Percentiles of Average Income Tax Rates by AGI, All Taxpayers



Source: OSPC.

Figure 4. 25th-75th Percentiles of Average Income Tax Rates by AGI, Single Filers, No Children



Source: OSPC.

A final perspective on the variance in tax liabilities is illustrated in Table 2, which breaks down the range of tax bills for all taxpayers, single taxpayers with no children, and married taxpayers with two children, with AGIs at both the 50th percentile and the 75th percentile. For example, roughly 40 percent of all median taxpayers have zero or negative tax liabilities, while 15.1 percent owe $2,500 or more in Federal income tax.

Table 2. Variance in Tax Liability by Household Size

	Median AGI			75 Percentile of AGI		
Tax Liability	All Tax Units	Single, No Children	Married, 2 Children	All Tax Units	Single, No Children	Married, 2 Children
<$0	37.6%	3.1%	100.0%	1.8%	0.0%	6.4%
$0	2.5	1.5	0.0	0.6	0.7	0.7
$1–$1,500	19.9	12.5	0.0	4.2	0.9	15.1
$1,501–$2,500	24.9	51.7	0.0	6.3	0.8	20.3
$2,501–$5,000	14.8	30.7	0.0	17.9	3.3	54.6
$5,001+	0.3	0.5	0.0	69.2	94.3	2.9

Source: OSPC.

The disparities in Federal tax liabilities for similarly situated taxpayers contributes, in my view, to a lack of confidence in the system by many taxpayers. After all, while the overall Federal income tax is progressive, nearly 20 percent of taxpayers who report $36,000 in AGI pay a higher average tax rate than 60 percent of taxpayers who earn $50,000. In short, many taxpayers are correct in their suspicion that higher-income earners are paying a lower tax rate, but importantly this is true across the entire income spectrum.

3. ITEMIZED DEDUCTIONS ARE DISTORTIONARY AND REGRESSIVE: THE STATE AND LOCAL TAX DEDUCTION EXAMPLE

Among the many provisions of the individual income tax code that narrow the tax base, itemized deductions are, as a group, the largest. As mentioned above, according to the IRS SOI, itemized deductions totaled $1.2 trillion in tax year 2015. Within this category, the largest itemized deduction was for State and local taxes (SALT). In 2015, $338 billion in SALT deductions were claimed. (Mortgage interest deductions totaled $279 billion and charitable giving deductions $201 billion.)

The revenue loss (calculated as the deduction amount multiplied by the weighted average marginal tax rate for taxpayers claiming the deduction) from reducing the tax base by $338 billion in a single year is quite large. According to my estimation, full repeal of the SALT deduction would raise $1.4 trillion over a decade. Of this, 89 percent—$1.26 trillion—would come from taxpayers with AGIs above $100,000. In other words, the policy itself is highly regressive. It is available only to the minority of taxpayers who itemize their taxes (generally higher-income taxpayers) and is more valuable to taxpayers in higher tax brackets (though for truly high-income earners and taxpayers on the AMT, the benefits are limited).

What is the purpose or rationale for a Federal tax deduction for State and local taxes? As the Congressional Budget Office (CBO) explains:

> The deduction for State and local taxes is effectively a Federal subsidy to State and local governments; that means the Federal Government essentially pays a share of people's State and local taxes. Therefore, the deduction indirectly finances spending by those governments when Federal revenues could be used to fund the activities of the Federal Government.[9]

Moreover, this Federal subsidy reduces the "tax price" for deductible State and local taxes for those taxpayers who itemize. For example, a $1 State income tax increase paid by a taxpayer in the 33 percent marginal tax bracket would reduce her Federal tax liability by $0.33, yielding a net additional cost to the taxpayer of $0.67. This reduced tax price can encourage States to rely on deductible taxes more and to impose more of those taxes on high-income taxpayers. In short, the SALT is, in

[9] Congressional Budget Office (CBO), "Limit the Deduction for State and Local Taxes," *Options for Reducing the Deficit: 2017 to 2026,* December 8, 2016, available at *www.cbo.gov/budget-options/2016/52253.*

isolation, a regressive tax policy at the Federal level and one that encourages a progressive income tax at the State and local level. As Kirk Stark observed in *Virginia Tax Review,* "All else equal, State and local governments will have an incentive to design their tax systems to take maximum advantage of the SALT subsidy, which suggests a strong price effect in favor of a more progressive tax system. Empirical studies have shown that the Federal deduction for State and local taxes exerts a substantial influence on subnational progressivity." [10] In fact, the most recent evidence of this empirical response, David Coyne finds that local governments are very sensitive to changes in the tax price with respect to their willingness to rely on deductible taxes.[11] He estimates that a 1 percent increase in the tax price will lead to a 3.5 percent reduction in the use of deductible taxes.

CBO continues:

> An argument in favor of capping the deduction is that the Federal Government should not provide a tax deduction that subsidizes the spending of State and local governments because revenues from State and local taxes are largely paid in return for services provided to the public. When used to pay for public services, such taxes are analogous to spending on other types of consumption that are nondeductible. . . . Additionally, the unlimited deductibility of taxes could deter States and localities from financing some services with nondeductible fees, which could be more efficient.[12]

Overall, the combination of high marginal tax rates on income earned by taxpayers claiming the largest share of itemized deductions yields a set of regressive and costly tax expenditures. The list is led by a policy that unfairly distorts State tax policy.

4. A BROADER TAX BASE CAN PROMOTE GREATER TAX NEUTRALITY

If lawmakers pursue a tax reform agenda with a commitment to broaden the tax base, the benefits can be categorized in two types: First, there are the direct benefits discussed above: the potential for a less complex tax code with lower compliance costs, a fairer tax system with less inequality among similarly situated taxpayers, and a less distortionary system that is also less regressive. (Such a result is not, however, to be assumed for all base-broadening policies, of course. For example, eliminating an exclusion of income, while perhaps desirable, could increase complexity or compliance.)

Second, there is an important indirect benefit: leveling the playing field and promoting economic efficiency by reducing tax-induced distortions in the allocation of resources. As my colleague Alan Viard and I wrote in an AEI *Tax Policy Outlook* in 2011:

> The economy is generally most efficient when the free market determines the allocation of resources between goods, based on production costs and consumer preferences. When different goods are taxed at different rates, efficiency is impeded because the allocation of resources is based partly on tax considerations, rather than costs and preferences. For example, if apples, but not oranges, are tax-deductible, the economy produces too many apples and too few oranges. Switching to a [single] tax on both goods corrects this misallocation, increasing the production of oranges and reducing the production of apples and yielding a set of goods consumers find more attractive. . . . Base broadening is likely to be most useful when it addresses the major distortions of the current tax system.[13]

However, some base broadening should certainly be avoided. The income tax, by its very nature, discourages savings and investment by taxing future consumption more heavily than current consumption. The current tax code includes a host of policies intended to mitigate or eliminate this distortion. While lower tax rates on dividends and capital gains, tax preferences for defined contribution plans, and other similar policies may appear on lists of tax expenditures, they in fact promote economic efficiency and should be preserved in even expanded.

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[10] Kirk J. Stark, "The Federal Role in State Tax Reform," *Virginia Tax Review* 30 (2010): 407.
[11] David Coyne, "Unmasking Local Fiscal Responses to Federal Tax Deductibility," *National Tax Journal* 70, no. 2 (2017): 223–256.
[12] CBO, "Limit the Deduction for State and Local Taxes."
[13] Alex M. Brill and Alan D. Viard, "The Benefits and Limitations of Income Tax Reform," AEI *Tax Policy Outlook,* September 2011, available at *www.aei.org/wp-content/uploads/2011/10/TPO-Sept-2011.pdf.*

5. TAX REFORM AND TRANSITION POLICY: FINDING THE BALANCE

The final point I would like to address relates to the transition policies necessary to consider in a fundamental tax reform effort that transforms the tax code from the one we have today to one consisting of a broader base (that is, with fewer expenditures) and lower statutory rates. In many respects, the transition rules—the tax policies that will feature prominently in the tax code in the intervening years—may be as important as the final tax policies. As lawmakers ponder the most appropriate strategies for crafting these rules, I would like to offer three observations.

First, if pursuing fundamental and broad-based reform, providing little or no transition relief risks imposing large and unanticipated tax hikes on unsuspecting taxpayers. Beyond the political challenges this may pose, it could yield painful adverse short-term economic effects. Second, the corollary is true, too. Overly generous and slow transition policies that delay needed reforms many years into the future will also delay the potential economic gains associated with tax reform.

And finally, when considering the budgetary impact associated with tax reform, the costs associated with transition policy—for example, that the "payfors" may phase in more slowly than a rate cut—are far less important than the budgetary impact of tax reform beyond the budget window. As I discussed in a recent article, lawmakers in pursuit of revenue-neutral tax reform should focus on the likely revenue impact of tax reform beyond the 10-year budget window rather than the impact within the budget window.[14]

In conclusion, the opportunity for fundamental reform of the individual income tax system is an opportunity to simplify the tax code, improve the equity of the system, and reduce distortions. Tax reform that wisely broadens the tax base can achieve these goals. To pursue the additional core objective of a tax reform that promotes economic growth, tax reform should also be careful not to increase the tax penalty on savings and should instead pursue opportunities to reduce the current savings penalty.

QUESTIONS SUBMITTED FOR THE RECORD TO ALEX M. BRILL

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

CAPITAL GAINS VERSUS ORDINARY INCOME

Question. Mr. Brill, Ms. Batchelder mentions how the gap between the capital gains tax rate and the higher ordinary income tax rate creates a large incentive for taxpayers to try to re-characterize ordinary income as capital gains. She proposes addressing this problem by "raising the capital gains rates to reduce this incentive."

But, to be clear, one equally effective way to address this problem is to reduce the ordinary income tax rates, right?

Answer. The differential in tax rates between wage income and capital income can encourage taxpayers to try to recharacterize their income to take advantage of the lower tax rate. The degree to which this behavior is incentivized is determined by the spread between tax rates. That spread can be reduced by either lowering the higher rate or raising the lower rate or a combination of the two. But it is important to recognize that raising the rate on capital income can discourage savings and investment, which are essential to encouraging investment and for promoting gains in productivity.

HIGH IMPLICIT MARGINAL TAX RATES

Question. Mr. Brill, Ms. Batchelder wrote something I really appreciated: "Low-income workers face some of the highest implicit marginal tax rates."

I think she's right, and it's a serious problem. But later in her testimony, she talked positively about a proposal from a member of this committee to increase the Earned Income Tax Credit and she notes that the proposal would phase the EITC out more rapidly.

[14] Alex Brill, "Investing in Tax Reform Today Will Yield a Strong Economy Tomorrow," *The Hill,* April 11, 2017, available at *www.aei.org/publication/investing-in-tax-reform-today-will-yield-a-strong-economy-tomorrow.*

But wouldn't a more rapid phase-out of the EITC increase the highest implicit marginal tax rate of those low-income workers in the phase-out range?

Answer. The EITC is an effective tax policy for encouraging work and reducing poverty, especially among taxpayers with children. Providing a tax incentive for low-income individuals to work, as the EITC does, without providing a subsidy to all taxpayers necessitates that the credit be phased out as incomes rise. There is, however, an unavoidable tradeoff in design if the policy were to be expanded. If enlarged, the credit must be phased out at a faster pace over the same range (thus creating a higher effective marginal tax rate) or it must be phased out over a broader range of income (thus extending the existing marginal tax rate bump to more middle-income taxpayers).

SALT DEDUCTION: REGRESSIVE OR PROGRESSIVE?

Question. Mr. Brill, you write on how the State And Local Tax (SALT) deduction is highly regressive, but that it encourages progressive State/local taxes. So, please explain more. Perhaps those two effects net out? If one thinks the tax laws needs to be more progressive, perhaps it's a good thing that the Federal SALT deduction encourages progressive State and local taxes? What do you think? A good thing or a bad thing?

Answer. The progressivity of State income tax systems is encouraged by the Federal deduction for State and local taxes. To some extent, the States are responding to the incentive to capture the Federal subsidy the deduction offers. By providing a subsidy generally only to high-income taxpayers—those who itemize—the code rewards States who rely on these taxpayers for their revenues. The degree of progressivity is a policy design by each State, and Federal tax policy should not attempt to steer that design choice. States should not be encouraged (or discouraged) from pursuing a progressive State tax system by the Internal Revenue Code.

TRANSITION POLICY

Question. Mr. Brill, I agreed with Ms. Harrison's point that: "If one were designing a tax system for the first time, one would likely devise something that is different from what we have already."

She then went on to state that some provisions in the tax code have been around for over a century, and thus many asset prices have the expectation of those tax provisions continuing.

So, Mr. Brill, please connect Ms. Harrison's good points with your thoughts on transition policy. Namely, it's certainly true we don't want, through tax law changes, to create tremendous upheaval, even if the new law will be more efficient in the long run. Your thoughts?

Answer. I would encourage the committee not to keep any existing policy in the tax code simply because it has been there for a long time. One objective of tax reform should be to establish a neutral tax code that minimizes interference with the market, absent clear evidence of a market failure. While asset values can certainly be affected by tax policy changes, I believe the idea that the U.S. residential housing market is inflated by the mortgage interest deduction is likely exaggerated. While my research on the topic is incomplete at this time, I would simply note that given the average price of homes in the U.S., current interest rates, and the effects of the standard deduction and personal exemption, a large number of homebuyers do not claim the mortgage interest deduction.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. In your opinion, did the 1986 Tax Reform Act solve the problems it was intended to fix? If so, please provide some examples of how. If not, why?

Answer. The Tax Reform Act of 1986 was a major legislative accomplishment. The tax base was broadened and statutory tax rates were reduced significantly. It was also a political accomplishment, as Democrats worked cooperatively with President Reagan to achieve these reforms. As Martin Feldstein has documented, TRA86 demonstrated that lower marginal tax rates yield increases in the amount of reported taxable income. As the 2006 Economic Report of the President notes, TRA86 also greatly narrowed the disparity in tax rates across asset classes, thereby reducing distortions in the types of investments made domestically.

Question. What metric or considerations should Congress use to determine appropriate trade-offs in tax reform?

Answer. I would encourage lawmakers to pursue a tax reform agenda with two main priorities: first, a simplification of the individual income tax system that reduces itemized deductions and moves more taxpayers to the standard deduction. This creates both a simpler system and a fairer tax code. Second, to the extent possible, I would encourage Congress to reduce the tax burden on savings and new investment, particularly in the corporate sector. A narrowing of the disparity in tax liabilities among similarly situated taxpayers and an increase in the domestic capital stock arising from a reduction in the tax on new investment will yield a tax code that is both fairer and more pro-growth.

A challenge to this task will be balancing the long-run budget consequence of tax reform with these goals. While deficit financing the transition cost of tax reform may be reasonable, the long-run fiscal outlook must be carefully evaluated.

Question. How would you suggest Congress address the skyrocketing cost of rental housing? Please provide some specific ideas to consider.

Answer. The cost of rental housing is often measured relative to the cost of purchasing a home, a metric referred to as the price-to-rent ratio. Nationally, that ratio is near its historical average, but trends vary across markets. To the extent that limited housing supply is pushing up rents, local policy reforms to permit more construction would be most appropriate. I would not support any tax policy geared to relieving the cost burden on renters.

SUBMITTED BY HON. MARIA CANTWELL, A U.S. SENATOR FROM WASHINGTON

From *The New York Times*

ECONOMISTS SEE LITTLE MAGIC IN TAX CUTS TO PROMOTE GROWTH

By Patricia Cohen and Nelson D. Schwartz

May 23, 2017

If one assumption has undergirded Republican economic policy for decades—and is the foundation of the Trump administration's first budget proposal—it is that tax cuts will unleash fantastic growth.

The basic idea is that shrinking the government's share increases what people take home, encouraging workers to work more and investors to invest more. But while taxes can create incentives that can promote growth, liberal and conservative economists alike said there was no evidence that the White House budget announced on Tuesday would do so.

"The assumed effects on growth are just huge and unwarranted," said William G. Gale, a co-director of the nonpartisan Urban-Brookings Tax Policy Center and a former economic adviser to the first President George Bush.

The Trump administration promises to cut taxes, keep revenues steady and crank out average annual economic growth of 3 percent, but neither the budget nor the tax reforms previously outlined in sketchy form provide enough detail to figure out if that will happen.

While the United States cruised along with 3 percent growth—and higher—in the late 1990s and mid-2000s, growth has not reached anywhere near that level since well before the recession. The best showing in the past decade was in 2015, when the annual rate of expansion hit 2.6 percent.

In 2016, the economy expanded at an annual rate of 1.6 percent, the weakest performance in 5 years. Even as economies in Europe and Asia show signs of life after years of stagnation or outright recession, expectations for faster growth soon in the United States have ebbed. Both the Federal Reserve and the Congressional Budget Office have projected a pace of less than 2 percent in the long run.

Since mid-March, yields on the benchmark 10-year Treasury bond have fallen from 2.62 percent to 2.28 percent on Tuesday, a sign that traders are discounting the likelihood of a sudden pickup in growth.

How Trump's Budget Would Affect Every Part of Government

Government spending would be cut substantially. See how every budget item would be changed.

Budget Item	10-year budget	10-year change	10-year percent change
Health	$5.11 trillion	−$2.02 trillion	−28.3%
Health care services	$4.78 trillion	−$1.91 trillion	−28.5%
Grants to States for Medicaid	$4.7 trillion	−$627 billion	−11.8%
Refundable premium assistance tax credit and cost sharing reduction	$559.6 billion	−$5.3 billion	−0.9%
Federal employees' and retired employees' health benefits	$220.4 billion	−$2.6 billion	−1.2%
Children's Health Insurance Programs (CHIP)	77.2 billion	+$13.9 billion	+21.9%
DOD Medicare-eligible retiree health care fund	$143.8 billion	−$3.8 billion	−2.6%
Health Resources and Services Administration	$66.2 billion	+$474 million	+0.7%
Reinsurance and risk adjustment program payments	$71.7 billion	–	–
Centers for Disease Control and Prevention	$49 billion	−$18 billion	−26.9%
Indian Health Service	$47.5 billion	−$5.8 billion	−10.9%

An analysis of Mr. Trump's tax plan by the bipartisan, nonprofit Committee for a Responsible Federal Budget estimated that the Federal debt would rise by $5.5 trillion over the first decade. Even if lower taxes encouraged people to save and invest more, the huge government deficits created by the budget would crowd out private investors and offset some of those direct effects, several economists said.

Alan D. Viard, a tax expert at the American Enterprise Institute, a conservative research organization in Washington, said he and other researchers had repeatedly found that "deficit-financed tax cuts were usually harmful to growth."

Cutting the tax on investment income, for example, delivers the most bang for the buck, Mr. Viard said, but unless the lost revenue is made up through increases in other taxes or spending cuts, the deficit will balloon and economic growth will suffer.

Previous Presidents have not had a lot of success using tax cuts to spur growth. "The historical record is pretty clear that large tax cuts don't pay for themselves through economic growth," said Michael J. Graetz, a professor of tax law at Columbia University.

The 1981 tax cut that President Ronald Reagan pushed through did provide a short jolt to the economy, Mr. Graetz said, but he pointed out that the administration was compelled to raise taxes in 1982 and 1984 to keep the deficit under control.

Tax cuts championed by President George W. Bush in 2001 and 2003 performed even worse. While the cuts temporarily stimulated spending by putting more money in people's pockets, they did not have much impact in enhancing the economy's ability to produce goods and services.

Both President Trump and the House Republicans' proposals reserve the biggest tax cuts for the wealthiest. Slashing rates at the top is probably the least effective way of spurring spending, however, because high-income households have the luxury of socking away a financial windfall, said Nariman Behravesh, chief economist at the research firm IHS Markit. The Trump plan, he said, "could well end up hurting a lot of poor people without boosting growth."

"If you tilt the tax cuts toward lower-income households, they will spend more of it," Mr. Behravesh said. "There is virtually no debate among economists about that."

And the deep cuts in the budget to programs that benefit primarily those at the bottom of the economic ladder will, if anything, reduce their spending.

The left-leaning Economic Policy Institute estimated that the budget cuts would decrease growth by more than 1 percent by 2020.

Many economists on the left and the right agree that the current code as it applies to businesses is misguided: It puts the United States at a competitive disadvantage and encourages corporations to keep income abroad. But fixing that problem isn't merely a matter of slashing rates.

"With the economy back to near full employment, conventional tax cuts or stimulus spending won't have that much of an effect," said Douglas Holtz-Eakin, a conservative economist who served in the George W. Bush administration and advised John McCain's 2008 presidential campaign. "What is needed are policies that genuinely augment the supply side of the economy."

What might that look like? Instead of simply cutting rates, Mr. Holtz-Eakin would opt for incentives for business to invest in new equipment or software, infrastructure investments that speed transportation and ease other frictional costs, and retraining that improves workers' skills and increases the proportion of prime-age Americans who are employed.

Mr. Viard of the American Enterprise Institute added tax relief for child-care expenses to the list of reforms that could bolster growth.

There are lots of reasons to tinker with the tax code, many experts say, but the notion that there is a simple cause-and-effect relationship between cuts and growth is faulty. "Tax policy is clearly not some overwhelmingly powerful tool that affects growth," Mr. Viard said. There are simply too many other things—like technology, worker productivity and aging—that can either muffle or overwhelm their impact.

In the months after Mr. Trump's unexpected victory in November, many business leaders and investors thought that the Washington logjam might finally break and that corporate tax reform, more infrastructure spending and other growth-friendly policies would be passed by Congress and signed into law.

But with Washington and the White House now distracted by the investigation into possible ties between former Trump aides and Russia, momentum for major tax cuts or a big infrastructure bill has stalled.

On Friday, the government will announce revised figures for growth in the first quarter of 2017, but not much improvement from the initial 0.7 percent estimate last month is expected.

Prepared Statement of Iona C. Harrison, Senior Vice President, Pioneer Realty

Introduction

Chairman Hatch, Ranking Member Wyden, and members of the Finance Committee, my name is Iona Harrison. I am a real estate professional working in Upper Marlboro, MD, and have been in the business my entire adult life. Currently, I serve as the chair of the Federal Taxation Committee of the National Association of Realtors (NAR), and I have served the real estate industry at the local, State, and national levels for many years in a variety of capacities.

I am here today to testify on behalf of the more than 1.2 million members of the National Association of Realtors. NAR's members are real estate professionals engaged in activities including real estate sales and brokerage, property management, residential and commercial leasing, and appraisal. The business approach of Realtors is a highly personal, hands-on, face-to-face model, focused on helping fulfill a family's fundamental need for shelter. NAR has long prided itself as a voice for not only its members, but for America's 76 million homeowners, as well as the millions more Americans who aspire to own their home one day.

Thank you for the opportunity to present NAR's views on how tax reform could affect individual taxpayers and residential real estate. Purchasing a home is one of the most significant events that most Americans undertake in their lives, and this activity interacts with our tax system in a fundamental way. Since its inception, the Internal Revenue Code has offered important incentives for purchasing and owning a home. As it pursues tax reform, Congress must have a full understanding of the impact that changing these provisions could have on American taxpayers, as well as on residential real estate markets and the economy as a whole.

NAR Principles for Tax Reform

NAR's recommendations are centered on three guiding tax policy principles:

- Our income tax system, despite its many flaws, has supported a home ownership system that is unequaled in the world. Tax reform must build on the positive aspects of our current system so that it continues to encourage and support home ownership.

- While some aspects of our current tax system are mind-numbingly complex, the housing and real estate tax rules create no undue or significant complexity burdens for the great majority of individuals. A quest for simplicity must not be allowed to override common sense.
- Income-producing real estate is vital for strong economic growth and job creation, and great care must be taken in tax reform to ensure that current provisions that encourage those results not be weakened or repealed. Further, we agree that the tax system should be improved to better incentivize the construction of low-income housing (such as through an enhanced Low-Income Housing Tax Credit), encourage more investment in income-producing real estate by the middle class, and to help families save for retirement security.

If one were designing a tax system for the first time, one would likely devise something that is different from what we have today. But we're not starting from scratch, particularly in the context of housing. Some provisions in the tax code, such as the deductions for mortgage interest and State and local taxes paid, have been part of the Federal tax code since our current income tax was instituted more than a century ago. Thus, the values of such tax benefits are both directly and indirectly embedded in the price of a home. While economists disagree about the best estimates of the value of those embedded tax benefits, they all generally agree that the value of a particular home includes tax benefits.

Real estate is the most widely held category of assets that American families own, and for many Americans, the largest portion of their family's net worth, despite the price declines of the Great Recession. Therefore, while NAR agrees that reform and revision to different portions of the individual tax code are warranted, and that the law should be simplified, we remain committed to preserving the current law's incentives for home ownership and real estate investment.

NAR believes that individual tax rates should be as low as possible while still providing for a balanced fiscal policy. NAR further believes that there should be a meaningful differential between the rates paid on ordinary income and capital gains on investments. However, NAR does not endorse a particular rate, nor does it believe that long established provisions in the code should be changed or eliminated solely to lower marginal tax rates. When Congress last undertook major tax reform in 1986, it eliminated or significantly changed a large swath of tax provisions, including major real estate provisions, in order to lower rates, only to increase those rates just 5 years later in 1991. Most of the eliminated tax provisions never returned and in the case of real estate, a major recession followed. Congress must be mindful that eliminating widely used and simple tax provisions can have harsh and dangerous unintended consequences, particularly if the sole purpose of eliminating non-abusive provisions is to obtain a particular marginal tax rate. NAR also notes that it is estimated that American homeowners already pay well over 80 percent of all Federal income taxes.[1] Congress should avoid further raising taxes on homeowners.

Many concepts of tax reform are based on the idea of lowering tax rates and broadening the tax base. This paradigm often leads to the conclusion that tax reform needs to "close abusive or unwarranted loopholes." However, very few "loopholes" have been identified. NAR firmly believes that the tax provisions that support home ownership are not loopholes. As 64 percent of American households are owner-occupied,[2] we believe that home ownership is not a "special interest," but is rather a "common interest."

NAR believes that tax reform must first do no harm to real estate.

Home Ownership and Tax Simplification

NAR supports the goals of simplification and structural improvements for the tax system. Nonetheless, we are unwavering in our support for the mortgage interest and property tax deductions and believe that other favorable housing provisions should be retained. These rules are among the most easily understood and widely supported in the entire tax system, so compliance is easily achieved.

The mortgage interest and property tax deductions sometimes come under fire because, in any particular year, only about one-third of taxpayers itemize their deduc-

[1] National Association of Realtors estimates.
[2] U.S. Census Bureau, January 2017.

tions. This criticism overlooks two essential points. First, even though the percentage of taxpayers who itemize has remained relatively constant over the past 25 years, the individuals who comprise the universe of itemizers changes from year to year. Younger taxpayers purchase their first home, older mortgages get paid off, a family's charitable contributions fluctuate, State and local tax burdens vary from State to State, and in some years, families face deductions for large medical expenses or casualty losses. In short, circumstances change.

Second, the standard deduction serves as a very generous proxy for itemizing. It provides, in relative terms, a greater tax benefit for the taxpayers who use it than itemizing would give them. For example, today's standard deduction on a joint return is $12,700. Suppose that if a family's total of mortgage interest expense, State and local taxes, charitable contributions and medical expenses were $8,700, they would receive the equivalent of a "free" extra exemption or deduction of $4,000 ($12,700 − $8,700). The standard deduction thus generally has the effect of sheltering some income from taxation. This is because taxpayers itemize only when allowable deductions exceed the standard deduction (*please see* The Enigma of the Standard Deduction, below).

NAR supports the current standard deduction. For most taxpayers, it is a substantial and significant simplification device that also, by sheltering some income from tax, adds progressivity to the system. Those who itemize receive no such benefit. As with standard deduction taxpayers, itemizers are found in all tax brackets. If they are in higher tax brackets, they do receive more tax benefit per dollar spent than itemizers in lower brackets. What critics often overlook, however, is that higher bracket taxpayers also pay more tax on each dollar of income than those in lower tax brackets.

Some recent tax reform plans feature a much higher standard deduction than is offered under the current system. Proponents of this change justify it by touting the additional simplification that could result from far fewer taxpayers itemizing. However, this simplification would come at a high price. Doubling or tripling the standard deduction, as some reformers suggest, destroys the incentive value of itemized deductions for most, as the great majority of taxpayers would receive the same tax benefit whether or not they engaged in the behavior the deduction is designed to encourage, whether it is to purchase a home or to donate to a charitable cause. Past increases in the standard deduction were justified on the grounds that the underlying itemized deductions had grown in value compared with an unindexed standard deduction. But under the current law, the standard deduction is adjusted each year for inflation, leaving little or no policy reason to increase it.

Moreover, one prominent recent tax reform plan purports to almost double the standard deduction, but in reality, a large portion of the increase is accomplished by shifting the current-law personal and dependency exemptions to the increased standard deduction. As a result, this change could greatly mitigate promised tax reductions for many present itemizers, and also lessen or eliminate the incentive effect of those itemized deductions. This is especially true for larger families.

For example, a family with four children with itemized deductions totaling $23,700 would have a total amount of combined deduction and exemptions under the current law of $48,000. This is from the itemized deductions plus six personal and dependency exemptions worth $4,050 each. However, under the proposed tax reform plan that the House Ways and Means Committee is reportedly considering, the total deduction and exemptions would be halved to just the $24,000 "higher" standard deduction. It is true that the Ways and Means plan includes a higher child tax credit, but this would not even come close to making up for the loss of the exemptions. Moreover, if one or more of the children were age 17 or older, there would be no offsetting increase in the child credit. Thus, larger families could pay a very high price indeed for the marginal amount of simplification that may be gained from the higher standard deduction under tax reform.

For these reasons, NAR opposes tax reform plans that significantly increase the standard deduction.

HOME OWNERSHIP AND AMERICAN CULTURE

Policymakers should not dismiss or underestimate Americans' passion for home ownership, notwithstanding the most recent economic crisis. Calling home ownership the "American Dream" is not a mere slogan, but rather a bedrock value. Owning a piece of property has been central to American values since Plymouth and Jamestown. Homes are the foundation of our culture, the place where families eat, learn and play together, and the basis for community life. The cottage with a picket fence is an iconic and irreplaceable part of our heritage.

The Nation's commitment to home ownership as a foundation of our society is not misplaced. Now, more than ever, home ownership does and should remain in the forefront of our cultural value system.

The fundamental assumptions about the social benefits of housing and home ownership remain essentially unchanged. NAR polling and focus group research confirm that the public continues to share those assumptions, including those who currently do not own their own home. An overwhelming majority (94 percent) of renters aged 34 and younger aspire to own a home. And among renters of all ages, 83 percent have a desire to own. Seventy-seven percent of them believe that home ownership is part of the American Dream.[3] Remarkably, even after the problems stemming from the 2003–2007 housing run-up, this faith in home ownership persists.

Research has consistently shown the importance of the housing sector to the economy and the long-term social and financial benefits to individual homeowners and communities. The economic benefits of the housing market and home ownership are immense and well documented.

The housing sector directly accounted for approximately 16 percent of total economic activity in 2016. Net of mortgage liabilities, real estate household equity totaled $13.7 trillion in the first quarter of 2017.[4]

In addition to tangible financial benefits, home ownership brings substantial social benefits for families, neighborhoods, and the Nation as a whole. These benefits include increased education achievement and civic participation, better physical and mental health, and lower crime rates. These economic and societal benefits do not change and will not change, despite the ups and downs and challenges of the housing market.

Our tax system does not "cause" home ownership. People buy homes to satisfy many social, family, and personal goals. Rather, the tax system facilitates ownership. The tax system supports home ownership by making it more affordable. While it is true that only about one-third of taxpayers itemize deductions in any particular year, it is also true that, over the home ownership cycle, a much higher percentage of taxpayers receive the direct benefit of the mortgage interest deduction. Over time, mortgages get paid off, other new homeowners enter the market and family tax circumstances change. Individuals who utilize the mortgage interest deduction (MID) in the years right after a home purchase are, over time, likely to switch to the standard deduction.

When academics talk about the MID and refer to it as an expenditure, they are speaking in the language of macroeconomics. In reality, the billions of tax dollars they see as an expenditure are the individual savings of millions of families. Every time homeowners make a mortgage payment, they are generally creating non-cash wealth for their families. Many seasoned Realtors describe their satisfaction in helping a family secure its first house and then a larger home(s) for raising families. The most satisfying of a long-term series of transactions is helping a couple buy its last house without a mortgage. Those couples are able to make this "last" purchase because ownership over a long term of years has resulted in savings sufficient to meet their needs.

The Federal policy choice to support home ownership has been in the Internal Revenue Code since its inception. We see no valid reason to reverse or undermine that basic decision. Indeed, we believe that the only viable tax system for America is one that would continue to nurture home ownership.

RESIDENTIAL REAL ESTATE TAX PROVISIONS

There are a number of provisions in the Internal Revenue Code that affect residential real estate in one form or another. These range from relatively minor temporary tax incentives to major provisions utilized by millions of taxpayers. While NAR generally supports tax provisions that encourage sustainable home ownership and that incentivize investment and improvement of real estate, we will focus here on the most prominent and widely used provisions for individual homeowners.

[3] "2015 Homeownership Opportunities and Market Experience (HOME) Survey," conducted by the National Association of Realtors.

[4] "Housing's Contribution to Gross Domestic Product (GDP)," National Association of Home Builders, *https://www.nahb.org/*.

The Real Property Tax Deduction

The income tax system of the United States has provided a deduction for State and local taxes, including property taxes, since its inception in 1913. To do otherwise would violate two fundamental and widely accepted principles of good tax policy—the avoidance of double taxation and the need to recognize the taxpayer's ability to pay.

Taxes paid at the State and local levels to benefit the general public are in nature and purpose similar to the Federal income tax in that they both fund essential government services. Therefore, allowing a deduction for these State and local taxes for Federal income tax purposes is essential to avoiding double taxation on the same income (or a tax on a tax). Our Federal tax law follows this same principle in connection with the payment of taxes to other nations. In the case of foreign taxes, however, the law goes even further and provides taxpayers with a choice of claiming a deduction for foreign taxes paid, or taking a credit, which is a dollar-for-dollar reduction in tax owed.

Some recent tax reform proposals would repeal the deduction for State and local taxes paid, ostensibly because the Federal deduction has been viewed by some as subsidizing State and local government activities, and even perhaps encouraging them to increase spending. Interestingly, very few, if any, critics suggest that the even more generous credit for taxes paid to a foreign government subsidizes spending by those nations, or encourages profligacy by them.

While State and local taxes vary greatly, two aspects of them that do not change are that they are ubiquitous throughout the Nation, in one form or another, and they are largely involuntary. Some would argue that we can exercise some degree of choice over how much we pay in State and local taxes by deciding where we live and what we buy. Others would point out that the degree to which this is possible is greatly limited by family circumstances and ties. However, avoiding these levies altogether is not a practical option. Obviously, paying taxes to State and local governments leaves taxpayers without the income used to pay the taxes. The extraction of State and local taxes is tantamount to the money never being earned by the taxpayer in the first place. Our tax system has always recognized this fact by providing a deduction for the payment of these taxes.

Eliminating the deduction for State and local taxes would fly in the face of these fundamental tax policy principles that have been ingrained in our income tax law from its beginnings.

For homeowners, real property taxes represent an unending obligation, at least as long as they own their homes. The other major deduction for most homeowners, the mortgage interest deduction, does not continue after the mortgage is paid off, and it usually diminishes as the mortgage is being paid. Property taxes, on the other hand, often increase over the years, as assessments on property increase and as local governments increase their levy rates. For these reasons, the deduction for real estate property taxes is often the one most-claimed by homeowners. In fact, significantly more taxpayers claim the real property tax deduction than claim the deduction for mortgage interest (in 2015, 44.1 million wrote off real property taxes while 32.7 million deducted mortgage interest).[5]

As with the mortgage interest deduction, critics sometimes claim that the deduction for property taxes is misguided because it gives the lion's share of its benefit to the wealthy and little to the rest of us. However, this is just not the case.

Much of this criticism is centered on the fact that taxpayers must itemize in order to take the deduction. As discussed below (*please see* The Enigma of the Standard Deduction), taxpayers who claim the standard deduction also benefit from the property tax deduction.

Further, because real property taxes are assessed based on property values, one would expect the deduction to be much more utilized at higher incomes. Moreover, most local governments grant real property tax relief to lower-income taxpayers.

Surprisingly, however, 70 percent of the value of real property tax deductions in 2014 went to taxpayers with incomes of less than $200,000, and 53 percent of those

[5] "SOI Tax Stats—Individual Income Tax Returns," Publication 1304 (Complete Report), updated 8/31/2016, *https://www.irs.gov/*.

claiming the itemized deduction for real estate taxes that year earned less than $100,000.[6]

In addition, the tax law already includes a provision designed to limit the tax benefit of the real property tax deduction to the "wealthy." Specifically, the deduction is disallowed for purposes of the alternative minimum tax.

Percentage of Tax Units That Use the SALT Deduction and the Average Deduction by State

State	Percent With SALT Deductions	Average SALT Deduction	State	Percent With SALT Deductions	Average SALT Deduction
MD	45%	$5,604	**NE**	28%	$2,992
CT	41%	$7,774	**ME**	28%	$2,997
NJ	41%	$7,045	**VT**	27%	$3,246
DC	39%	$6,056	**SC**	27%	$2,224
VA	37%	$3,998	**MI**	26%	$2,434
MA	37%	$5,421	**OH**	26%	$2,650
OR	36%	$4,211	**MO**	26%	$2,436
UT	35%	$2,753	**KY**	26%	$2,438
MN	35%	$4,273	**AL**	26%	$1,457
NY	34%	$7,182	**KS**	26%	$2,338
CA	34%	$5,807	**NV**	24%	$1,422
RI	33%	$3,985	**OK**	24%	$1,878
GA	33%	$2,830	**IN**	23%	$1,916
CO	33%	$2,796	**MS**	23%	$1,418
IL	32%	$4,164	**LA**	23%	$1,519
DE	32%	$2,787	**NM**	23%	$1,557
WI	32%	$3,551	**AR**	23%	$1,993
NH	31%	$3,003	**TX**	22%	$1,694
WA	30%	$2,125	**FL**	22%	$1,548
IA	29%	$2,812	**WY**	22%	$1,244
HI	29%	$2,624	**AK**	21%	$1,023
NC	29%	$2,629	**TN**	20%	$1,043
PA	29%	$3,083	**ND**	18%	$1,211
AZ	28%	$1,977	**SD**	17%	$982
MT	28%	$2,483	**WV**	17%	$1,535
ID	28%	$2,312			

Source: *The Impact of Eliminating the State and Local Tax Deduction,* (based on 2014 IRS data), Government Finance Officers Association.

The Mortgage Interest Deduction

The deduction for mortgage interest paid has been part of the Federal income tax code since its inception in 1913. Despite more than a century of additions, modifications, deletions, and overhauls of the tax code, Congress has left the mortgage interest deduction in place. Current law allows a homeowner to deduct the interest on up to $1 million in total acquisition debt for a principal residence and a second, non-rental, home. Homeowners are also allowed to deduct the interest on up to $100,000 in home equity debt.

Prior to 1986 there was no limit on the amount of home mortgage interest that could be deducted. The Tax Reform Act of 1986 imposed the first limitation on the MID, allowing it for allocable debt used to purchase, construct or improve a designated primary residence and one additional residence (second home).

The Omnibus Budget Reconciliation Act of 1987 further limited the deduction to interest allocable to up to $1 million in acquisition debt. This limit is not adjusted for inflation. Factoring in the impact of inflation, the value of the cap has eroded by half since 1987; in 2014 dollars, the original cap would be equal to over $2 million today had it been indexed.

Who Benefits From the Mortgage Interest Deduction?

The mortgage interest deduction (MID) is often criticized on two fronts—that it benefits only those relatively few taxpayers who are eligible to itemize their deductions, and that it favors wealthier taxpayers at the expense of those with more mod-

[6] "SOI Tax Stats—Individual Statistical Tables by Size of Adjusted Gross Income," Table 2.1, Tax Year 2014, *https://www.irs.gov/*.

est incomes. Since taxpayers who itemize are often those with higher incomes, these criticisms are related.

In 2015, the most recent tax year for which IRS data are available, 32.7 million tax filers claimed a deduction for mortgage interest.[7] While tax filers claiming the MID account for less than a quarter of the total number of tax returns filed, returns claiming the MID represent closer to half of owner-occupied households and roughly two-thirds of homeowners whose homes are mortgaged.

Furthermore, the percentage of homeowners claiming the benefits of the MID at some stage of the home ownership cycle is much higher. Over the course of an owner's tenure in a home, an individual may itemize in the early years of home ownership, when the interest expense is high relative to the principal paid, but then not itemize in later years. Mortgages get paid off, other non-MID deductions rise and fall, individuals down-size, divorces occur, a spouse dies or needs to simplify living arrangements. These and other life events may convert itemizers into standard deduction taxpayers. Thus, in any given year, we will not see the full contingent of homeowners who use the MID at some stage over the time they own their homes.

As to the charge that the deduction predominately favors the wealthy, statistics show that this is simply not the case. Rather, the MID is valuable and utilized by households across the income spectrum. Fifty-three percent of those claiming the MID in 2015 earned less than $100,000 and 85 percent had Adjusted Gross Incomes of less than $200,000. Further, 76 percent of the value of the MID in that year went to those earning under $250,000 per year.[8]

Facts on the Mortgage Interest Deduction in the U.S.

	Share of homeowners with mortgage	Number of taxpayers claimed the MID	Average amount subtracted from taxable income	Average taxpayer savings in taxes	Total tax savings from the MID
United States	63.8%	32,111,500	$8,700	$2,170	$69,768,843,000

Mortgage Interest Deduction for Each State

State	Share of homeowner with mortgage	Number of taxpayers claimed the MID	Average amount subtracted from taxable income	Average taxpayer savings in taxes	Total tax savings from the MID
Alabama	57.4%	390,500	$7,300	$1,820	$712,165,000
Alaska	66.1%	66,700	$9,600	$2,400	$160,041,750
Arizona	64.4%	625,300	$8,950	$2,230	$1,395,437,250
Arkansas	55.6%	199,000	$6,550	$1,640	$326,849,750
California	71.9%	4,207,200	$12,400	$3,100	$13,040,866,250
Colorado	72.8%	683,200	$9,550	$2,390	$1,634,558,750
Connecticut	69.9%	536,200	$8,750	$2,190	$1,174,603,000
Delaware	69.4%	115,700	$8,900	$2,220	$257,068,250
District of Columbia	76.0%	77,900	$12,350	$3,090	$240,670,750
Florida	58.1%	1,465,400	$9,100	$2,280	$3,335,480,000
Georgia	66.9%	1,066,400	$7,700	$1,930	$2,056,481,750
Hawaii	66.3%	140,300	$12,800	$3,200	$448,732,750
Idaho	65.8%	154,100	$7,600	$1,910	$293,572,250
Illinois	65.0%	1,488,600	$7,700	$1,930	$2,868,501,000
Indiana	66.7%	557,900	$6,400	$1,610	$895,719,000
Iowa	60.7%	302,400	$5,900	$1,470	$445,098,500
Kansas	60.3%	250,800	$6,600	$1,660	$415,260,500
Kentucky	59.4%	381,100	$6,250	$1,560	$595,903,500
Louisiana	53.2%	315,300	$7,500	$1,880	$592,514,250
Maine	62.3%	137,000	$6,950	$1,740	$237,742,000
Maryland	73.5%	951,300	$10,000	$2,490	$2,372,916,500
Massachusetts	69.5%	934,900	$9,200	$2,300	$2,153,170,500
Michigan	61.6%	958,600	$6,700	$1,670	$1,600,460,500
Minnesota	66.8%	735,600	$7,850	$1,960	$1,444,535,000
Mississippi	51.2%	189,200	$6,500	$1,620	$306,364,250
Missouri	62.7%	547,700	$6,800	$1,700	$933,184,000

[7] *Individual Income Tax Returns, Preliminary Data, Tax Year 2015,* Internal Revenue Service, Statistics of Income Bulletin, Spring 2017, *https://www.irs.gov/.*

[8] *Ibid.*

Mortgage Interest Deduction for Each State—Continued

State	Share of homeowner with mortgage	Number of taxpayers claimed the MID	Average amount subtracted from taxable income	Average taxpayer savings in taxes	Total tax savings from the MID
Montana	55.1%	100,100	$7,600	$1,900	$189,737,000
Nebraska	61.1%	179,000	$6,050	$1,520	$271,533,250
Nevada	68.4%	240,900	$9,500	$2,380	$572,154,500
New Hampshire	67.0%	173,800	$8,300	$2,070	$360,497,000
New Jersey	68.4%	1,252,700	$9,150	$2,290	$2,864,940,250
New Mexico	56.3%	157,500	$8,150	$2,040	$321,520,500
New York	62.4%	1,961,500	$8,800	$2,200	$4,322,713,500
North Carolina	64.4%	991,000	$7,650	$1,910	$1,897,594,750
North Dakota	51.9%	43,800	$7,650	$1,910	$83,533,250
Ohio	64.0%	1,137,400	$6,150	$1,540	$1,749,842,250
Oklahoma	56.0%	275,200	$6,650	$1,670	$458,660,250
Oregon	66.1%	497,400	$8,450	$2,120	$1,052,620,500
Pennsylvania	60.6%	1,354,200	$7,300	$1,820	$2,465,775,250
Rhode Island	69.9%	135,900	$7,700	$1,930	$261,863,750
South Carolina	58.6%	444,600	$7,500	$1,870	$830,953,000
South Dakota	54.7%	49,400	$7,350	$1,840	$90,823,000
Tennessee	59.9%	443,600	$8,050	$2,010	$890,610,000
Texas	58.3%	1,975,500	$7,800	$1,950	$3,851,842,000
Utah	71.0%	342,900	$8,300	$2,070	$711,404,250
Vermont	62.9%	68,100	$7,100	$1,770	$120,821,250
Virginia	69.9%	1,127,300	$10,250	$2,570	$2,894,670,250
Washington	69.0%	826,200	$10,350	$2,580	$2,134,631,500
West Virginia	46.3%	100,600	$6,800	$1,710	$171,573,750
Wisconsin	65.1%	678,600	$6,300	$1,580	$1,069,723,750
Wyoming	58.1%	46,300	$9,000	$2,250	$104,392,500

Sources: 2014 Internal Revenue Service, 2014 American Community Survey.
NAR Calculations

THE ENIGMA OF THE STANDARD DEDUCTION

While it is true that a taxpayer must itemize in order to claim the mortgage interest deduction, it is not true that those who do not itemize get no value from the MID. To appreciate this conundrum, one must look at the history of our modern tax system. In 1913, Congress and the President enacted the income tax. The original tax law provided for both a deduction for interest paid and for State and local taxes paid (including for property taxes). These two deductions, plus the deduction for charitable contributions, which was added to the tax law in 1917, together comprise the majority of itemized deductions that are claimed each year.

For many years, the tax law provided that taxpayers who paid interest, State and local taxes, and/or made charitable contributions, could take a deduction for them. A few other deductions, such as for casualty and theft losses or for medical expenses, were also allowed. However, to qualify for these deductions, taxpayers actually had to incur these expenses and keep track of them.

This changed in 1944, when Congress decided to simplify the tax law by enacting the standard deduction. Legislative history (both original and subsequent) shows that the standard deduction was based on a composite basket of typical deductions that taxpayers claimed, including the MID, taxes paid, charitable contributions made, and so forth. The simplification came about by Congress deeming that all individuals were to receive a certain amount of generic deductions, represented by the standard deduction. Taxpayers claiming the standard deduction did not need to prove that any amounts were actually paid in order to take the standard deduction. Congress simply designated that all taxpayers could claim the standard deduction whether they made the deductible expenditures or not.

In enacting the standard deduction, Congress did not modify the deductions themselves. Rather, taxpayers who paid deductible expenditures exceeding the standard deduction were allowed to claim the actual amounts as what was (from then on) called itemized deductions. Taxpayers with deductions totaling an amount below the standard deduction threshold could simply claim the standard amount and not worry about even keeping track of what was actually paid. This was a huge step toward simplifying the lives of millions of American taxpayers.

What is often not recognized today is that the standard deduction represents a tax giveaway for virtually all taxpayers who claim it. This is because if a taxpayer has deductions in excess of the standard deduction, he or she may claim the higher amount. But those who have actual deductions less than the standard are given the benefit of the standard deduction amount whether or not they actually incurred the expenses. Thus, the giveaway equals a range of as much as the standard deduction for taxpayers who have absolutely no deductions, on the high end, to as little as $1 for taxpayers whose actual deductions come just $1 short of the standard deduction amount, on the low end.

For example, assume a married couple's actual amounts for State and local tax, mortgage interest, and charitable contributions for 2017 total $12,000. With the standard deduction for a couple currently at $12,700, this family would be receiving an extra tax deduction for $700 in expenditures they never made. If they were in the 28 percent bracket, this would amount to a $196 tax "freebie" ($700 excess × 28%). Suppose another couple had just $2,000 of State and local taxes, but no mortgage interest and no charitable contributions. This family would also get to claim the standard deduction of $12,700, for a subsidy of $10,700 ($12,700 − $2,000), which would be worth $2,996, assuming they were also in the 28 percent tax bracket ($10,700 × 28%).

The point is that whether a taxpayer is being subsidized a little bit (as with the first couple), or a lot (as with the second couple), or not at all (as with the case of a couple who has enough deductions to itemize), each couple is benefitting from the mortgage interest and property tax deductions. Just because the standard deduction does not specifically indicate which portion of it is attributable to the MID or property tax (or any other deductions), does not mean that these deductions for home ownership are not part of the benefit being given.

When Congress first established the standard deduction in 1944, more than 82 percent of taxpayers were able to utilize this simplification tool, meaning that just 18 percent itemized. According to the Joint Committee on Taxation (JCT), by 1969 this proportion of non-itemizers had dropped to 58 percent. In explaining the reason for Congress increasing the standard deduction in the Tax Reform Act of 1969, JCT stated that since 1944, "higher medical costs, higher interest rates, higher State and local taxes, increased home ownership, and more expensive homes have made it advantageous for more and more taxpayers to shift over to itemized deductions." [9]

Thus, it is clear that even though no specific portion of the standard deduction is tied to the MID and property tax deduction, Congress crafted the standard deduction to be a proxy for allowable deductions (*i.e.,* itemized deductions), including the MID and State and local tax deductions, and when the underlying amount of these deductions increase, Congress has believed that it is appropriate for the standard deduction to also increase. It is also clear that Congress intended that most taxpayers would claim the standard deduction (82 percent in 1944) and when this proportion was eroded by inflation and other factors, Congress increased the standard deduction to keep it closer to its original percentage.

Arguments that the mortgage interest and real property tax deductions benefit only those who itemize simply do not hold water.

TAX REFORM PROPOSALS TO LIMIT THE TAX BENEFITS OF HOME OWNERSHIP

In recent years, a variety of tax reform ideas have been proposed that would limit the ability of certain taxpayers to claim the mortgage interest and/or the property tax deductions, or in other ways reduce the incentive effect of these provisions. Each of these proposals would limit the value of the deductions and have a negative impact on the value of housing. In many cases, the largest impact would be felt by middle-class families, not necessarily by the individuals or families categorized by the media as "the rich." The following is an examination of each of these proposals.

Capping Itemized Deductions

Two proposals have repeatedly been floated to cap the value of all itemized deductions. The first is a proposal that was included in several of President Obama's budgets to cap itemized deductions for upper-income taxpayers at 28 percent. As itemized deductions follow taxpayers' top marginal rate, this would have the effect of lessening the value of all itemized deductions for individuals in the 33 percent, 35 percent and 39.6 percent brackets. It is important to note that many of these taxpayers have already had the value of their deductions limited by the reinstatement of the complex and burdensome "Pease" limitation that applies to individuals

[9] "Summary of H.R. 13270, the Tax Reform Act of 1969," Joint Committee on Internal Revenue Taxation and the Committee on Finance, August 18, 1969.

with adjusted gross income above $250,000 for singles and $300,000 for couples (adjusted for inflation) as part of the American Taxpayer Relief Act of 2012.

The 28-percent cap focuses on the tax filer's income, rather than the total dollar amount of itemized deductions. This proposal adds, rather than removes, complexity from the tax code and would be difficult to plan for. An individual, particularly one who owns a business or who is self-employed, may be in different tax brackets from year to year. These individuals have a particularly difficult time estimating their incomes and tax liability, especially in today's uncertain economic and legislative climate. They do not need added burdens of complexity or unanticipated tax increases. A reduction in the mortgage interest and State and local tax deductions would further complicate their family finances.

Some will say that putting a limitation on the deductions of upper-income taxpayers would cause no harm for those in lower brackets. However, when reduced tax benefits reduce the value of a home, the value of all homes decreases. A collapse or reduction in home values at the top end of the market causes downward pressure on all other homes. That is, when the value of my neighbor's house declines, then the value of my house declines, as well.

The second proposal to cap itemized deductions comes in the form of a hard dollar cap on all itemized deductions. Most prominently proposed by Republican nominee Mitt Romney during the 2012 Presidential election, a dollar cap would disallow deductions above a certain dollar figure regardless of income.

As the cap is not based on income, but rather the amount of deductions claimed, this proposal would potentially raise taxes on Americans of all income levels regardless of where the dollar amount of the cap was set. For example, if the cap on total deductions were set at $25,000, households with cash incomes as low as $30,000 could be impacted, according to the Tax Policy Center (TPC). TPC further estimated that 35 percent of households with cash incomes between $100,000 and $200,000 would see a tax increase averaging almost $2,500 if itemized deductions were capped at $25,000.[10]

Not only does a dollar cap affect taxpayers of all income levels, it penalizes those who live in areas with higher housing costs or higher State and local taxes. Taxpayers living in these areas have somewhat "fixed" deduction costs when it comes to their mortgage and tax levels. Their property tax levels are directly tied to the value of their property and the local tax rate. While, in theory, they can pay down their mortgage amount and reduce their interest paid if they have the financial ability to do so, neither the mortgage nor the tax amount paid are discretionary, as is a charitable donation. Therefore, while it is widely viewed that charities would take the biggest hit from a dollar cap on total itemized deductions, one could argue the biggest losers would be younger families living in high cost housing markets who have both larger mortgage interest payments and high State and local tax bills. Their tax increase would be the most pronounced and painful, despite the idea that a dollar deduction cap is designed to simply make "the rich" pay their fair share.

If a dollar cap were implemented on itemized deductions, no matter the dollar amount, more and more taxpayers would be subject to it if Congress failed to index that amount for inflation. This would create the same kind of tax nightmare that came about as a result of the Alternative Minimum Tax, as more and more middle-class taxpayers became subject to the cap as home values and taxes paid rose, simply because of inflation. After spending years struggling to exempt most middle-class taxpayers from the AMT, it would seem odd Congress might consider falling into a similar quagmire again. Further, a dollar cap would add one more layer of complexity to the tax code and would be a rather blunt instrument to raise revenue.

Converting the Mortgage Interest Deduction to a Tax Credit

Many economists have traditionally favored tax credits over tax deductions because tax credits provide more benefit to those in lower tax brackets. This reflects the reality that, in a progressive tax system like ours, an individual in the 15 percent bracket receives only 15 cents of tax reduction for each dollar of interest deducted, while an individual in the 35 percent bracket receives a benefit of 35 cents on the dollar. The mathematics of this assertion is correct, but asymmetrical—the tax benefit analysis of a deduction ignores the balance between tax rates and individual income taxation. An individual in the 15 percent bracket pays only 15 cents of tax on a dollar of income, while an individual in the 35 percent bracket pays tax

[10] "On the Distributional Effects of Base-Broadening Income Tax Reform," Urban-Brookings Tax Policy Center, August 1, 2012.

of 35 cents on the dollar. Thus, tax rates balance, rather than distort, the value of deductions.

In 2005, President Bush's tax reform advisory council proposed converting the deduction to a 15-percent non-refundable tax credit. The Simpson-Bowles Commission subsequently proposed a 12 percent non-refundable tax credit along with its proposals to eliminate the deduction for second homes and capping the total deduction at $500,000. Others have proposed credits of different amounts and with different limitations on the total amount of mortgage debt that could be claimed or on the number of homes. In order to more carefully weigh the pros and cons of converting the deduction to a credit, NAR commissioned outside research in 2005 to study the effects of such a conversion.

While the conclusions are now somewhat dated, they present a striking contrast with the 12-percent or even 15-percent credit proposals. In 2005, NAR asked its consultants to design a revenue-neutral tax credit based on data then currently available. (Revenue neutrality was intended as a design under which the total amount of the tax expenditure associated with mortgage interest was neither increased nor decreased.) That analysis showed that in 2005, a revenue-neutral rate for a credit would have been 22 percent—markedly more beneficial to taxpayers than a 12 percent or 15 percent credit.

The amount of the credit percentage would greatly affect the number of winners and losers in any conversion. However, different studies have consistently shown that the tax increases for the losers would be far greater than the tax savings experienced by the winners. Also, the loss of the tax benefit would almost certainly result in the drop of value of all homes, as discussed above in the analysis regarding the proposal to cap itemized deductions. Furthermore, a conversion to a credit would upend over 100 years of established tax law. The effects this drastic of a change would have on consumers and the real estate markets is unknowable. In this case we think Congress would be well advised to adopt the mantra of "do no harm."

Eliminating the Deduction for Second Homes

Several proposals for tax reform, including Simpson-Bowles, have included a proposal to eliminate the deduction for second homes. Critics of the second home deduction argue that it primarily benefits rich owners of expensive vacation homes in resort areas like Aspen or Cape Cod. In reality, those taxpayers are seldom the beneficiaries of the deduction, as such homes are often purchased with cash.

When a Second Home is not a "Second Home"

One often overlooked reason for the code allowing a deduction for mortgage interest paid on a second home in a tax year is the most fundamental part of residential real estate: buying and selling. If a family has a mortgage on their primary residence, and then purchases another home with another mortgage before they can sell the first residence, such as in connection with a move for a job change, they will have owned two homes in that year. Removing the deduction for second homes would only allow the family to deduct the interest for one of those residences and essentially introduce a tax on moving. Families move for many different reasons: more space for a growing family, downsizing once the kids are gone, economic challenges, or a new job.

Second Homes Are Both Geographically Concentrated and Diverse

While the image conjured up by critics of a second home is a multi-million-dollar property in a tony resort area, most of those homes are bought with cash. In reality, second homes nationally have a lower median sales price than principal residences. Over the past decade, the median price of a second home has always trailed the median price of a principal residence.

NAR data show that in 2016 the median income of a second homeowner was $89,900.[11] While that income level is above the national median, it is certainly not the definition of "rich" that many consider when debating tax changes to "soak the wealthy."

Finally, NAR has compiled data identifying all U.S. counties in which more than 10 percent of the housing stock is second homes. Currently, about 900 of the Nation's 3,068 counties (roughly 30 percent) fall into this group. In some counties with very small populations, second homes can represent about 40 percent of the housing stock. In Meagher County, Montana, for example, the population is only 1,891 peo-

[11] "2017 NAR Investment and Vacation Home Buyers Survey," *https://www.nar.realtor.*

ple, but second homes represent 42 percent of the housing stock. That area is doubtlessly dependent on the jobs and property taxes generated by those second homes.

Thus, about 30 percent of U.S. counties have a stake in retention of the mortgage interest deduction for second homes. Those properties generate valuable jobs and property and sales taxes for the communities. To eliminate the MID for second homes would have at least as dramatic an impact on those communities as it would the taxpayer/owners themselves. Congress needs to carefully consider the economic impact on these communities, often located in rural areas with little other economic resources vs. the amount of revenue that could be raised from eliminating the deduction for second homes. The decline in home values and economic activity in those areas where the economy is driven by second homeowners could very well eclipse the small amount of revenue that could be gained by increasing taxes on these homeowners.

Reducing the Amount of Qualified Mortgage Debt

Another proposal to "raise revenue" is to lower the cap on the amount of acquisition debt eligible for the mortgage interest deduction from $1 million to $500,000. As previously discussed, the $1 million limitation was put in place in 1987 and is not indexed for inflation. Consequently, the value of the MID has eroded by more than half in 30 years.

Critics of the MID argue that lowering the limitation to $500,000 would affect a relatively small number of wealthy taxpayers. In fact, research conducted on behalf of NAR shows that individuals in every adjusted gross income (AGI) class, even as low as $10,000, have mortgage debt in excess of $500,000. Those in the lower income ranges likely include those who are self-employed with minimal income after expenses, those who are business owners with significant losses or retired individuals with other tax-exempt income. No matter what the income category, however, reducing the cap would make their economic positions worse, particularly where there have been losses.

Further findings from research conducted for NAR shows almost half of taxpayers with mortgages over $500,000 have AGI below $200,000.

Among those who itemize and claim MID, the AGI classes below $100,000 comprise 53 percent of all tax returns.[12] Moreover, the AGI classes below $200,000 represent almost 90 percent of all itemized returns.[13] Thus, the overwhelming majority of tax returns with MID are certainly NOT in so-called "Warren Buffett" territory.

A $500,000 cap has wildly divergent geographic implications. The burden of the cap would be disproportionately borne by taxpayers in high costs areas, even though they might not be categorized as "rich" and even though they may have fairly modest homes. Those living in high cost areas pay a disproportionately larger amount of their after-tax income toward housing than do taxpayers in other parts of the country. Eliminating part of the MID for them would exacerbate that disparity and in fact make home ownership even less affordable for many families. Some have proposed addressing this geographic issue by tying the limits of the MID to area housing prices in a way similar to formulas used to calculate loan limits for the Federal Housing Administration (FHA). NAR would resist any effort to make the cap on the MID contingent on the taxpayer's place of residence. Such a change would impose significant complexity on what is currently a very simple provision.

There is another factor Congress should take into consideration if contemplating a lower limit on the amount of home mortgage debt eligible for the interest deduction. This is the fact that unless such a cap is indexed for inflation, it may soon become a de facto limitation on the deduction for taxpayers Congress did not intend to hit. Again, the experience with the Alternative Minimum Tax should be instructive. Based on internal NAR calculations, by 2043 the value of more than half the homes in a majority of the 50 States will be greater than $500,000. And those projections show that 49 States will have at least 30 percent of their homes with a value exceeding this amount. Thus, in a relatively short time, the majority of American homes could be affected by a limit now intended to strike only the "wealthy."

[12] "Individual Income Tax Returns, Preliminary Data, Tax Year 2015," Internal Revenue Service, Statistics of Income Bulletin, Spring 2017, *https://www.irs.gov/*.

[13] *Ibid.*

Increasing the Standard Deduction and Repealing Most Itemized Deductions

More recently, Republicans in the House of Representatives have put forward a tax reform plan called "A Better Way," which is informally known simply as "The Blueprint."

While we laud the goals of this tax reform plan, and marvel at its boldness, we have great concern with the way one aspect of the Blueprint could affect residential real estate. This concern is that the interaction of two features of the plan, which are designed to simplify the tax system, would have the unintended consequence of nullifying the long-standing tax incentives of owning a home for the great majority of Americans who now are, or who aspire to become, homeowners.

Specifically, the Blueprint calls for the standard deduction to be almost doubled from its current levels. The plan also includes the repeal of the deduction for State and local taxes paid, as well as the elimination of most other itemized deductions. Either of these monumental changes alone would marginalize the value of the current-law tax incentives for owning a home. Unfortunately, the combination of these two revisions would cripple the incentive effect of the Federal tax law for all but the most affluent of taxpayers.

We anticipate two potentially devastating problems in the aftermath of these modifications. First, the impact on the first-time homebuyer could be enormous, despite them likely facing lower prices. For many, the current-law tax incentives make the crucial difference in being able to afford to enter the ranks of homeowners. At a time when the rate of first-time home-buying is well below the average of the past few decades, this could be particularly debilitating for the housing industry and the entire economy.

Furthermore, a tax reform approach like this would discriminate against current and aspiring homeowners in favor of renters. Research conducted for NAR on a Blueprint-like tax reform plan shows that home-owning families with incomes between $50,000 and $200,000 would face average *tax hikes* of $815 in the year after enactment while non-homeowners in the same income range would enjoy average annual *tax cuts* of $516.[14]

Also, these estimates show that under a Blueprint-like plan, nearly 46 million households would see their taxes go up. But 70 percent of them would be homeowners. Among the 25 million middle-income households ($50,000 to $200,000) with a tax increase, 85 percent would be homeowners.

Homeowners already pay 83 percent of all Federal income taxes, and this share would go even higher under similar reform proposals. Homeowners should not have to pay a higher share of taxes because of tax reform.

Second, the decimation of the mortgage interest and real property tax deductions would very likely cause a significant plunge in the value of all houses. At a time when the housing sector has not fully recovered from the thrashing it took during the Great Recession, this drop, even if temporary, could be calamitous. Millions of homeowners could again wake up to learn that the value of their largest financial asset has dived below the amount of debt that is owed on it.

Estimates provided for NAR show that values could fall in the short run by more than 10 percent if a Blueprint-like tax reform plan were enacted.[15] The drop could be even larger in high-cost areas. It may take years for home values to rebound from such a significant decrease.

The combination of these two problems could have further ramifications that could produce a vicious spiral. Should home values drop due to the decrease in value of home ownership incentives, revenues to State and local governments would surely follow suit because of lower assessed property values. Further, public pressure on these same governments to lower tax rates because these tax payments would no longer be deductible could greatly exacerbate the situation. The overall result could be a disastrous downturn in the quality of many neighborhoods and communities, and especially our most vulnerable ones.

In sum, it is estimated that a Blueprint-like tax reform approach could reduce the amount of Federal tax expenditures for home ownership by 82 percent over 10 years, from $1.3 trillion to just $232 billion.[16] This is certainly not the expected re-

[14] Available on NAR's website: *http://narfocus.com/billdatabase/clientfiles/172/21/2888.pdf.*
[15] *Ibid.*
[16] *Ibid.*

sult from a tax reform plan that purports to preserve the mortgage interest deduction.

Even if the hoped-for economic growth from the Blueprint materializes, it will take years for the full effects of these changes to permeate through the economy and for the effects to offset the deleterious short- to mid-range effects mentioned above. And many homeowners, particularly those who are middle-aged or older and are planning to use the equity in their home for retirement or to pay for the education of their children, simply will not have time to wait for the recovery.

ADDITIONAL RESIDENTIAL REAL ESTATE PROVISIONS

In addition to the deductions for mortgage interest and property taxes paid, there are two other tax provisions that have a large impact on a family's ability to sell their home. One of these provisions is permanent and should be preserved while the other is temporary and should be made permanent.

Capital Gains Exclusion for Sale of a Principal Residence

Prior to 1997, the tax rules that governed the sale of a principal residence were complex and largely ignored (section 1034 of the Internal Revenue Code). The general rule was that there was no recognition of gain, so long as the seller purchased a home of the same or greater value within a specified time. This was a particular disadvantage to individuals who relocated from a high cost area to a lower cost area. The deferred gain from the sale reduced the basis of the new home. Other elaborate rules required taxpayers to track the adjusted basis of the homes they owned so that, in the event that they did not purchase a replacement home (or purchased a replacement home of lesser value), the gain on that sale became taxable, as measured from the adjusted basis. Few taxpayers had adequate understanding of the law or sufficient records to enable them to comply with these rules.

In 1997, the Clinton administration, without input from NAR or others in the housing industry, proposed a complete overhaul and simplification of these rules. Rather than require elaborate basis computations on multiple residences over a term of many years, the new rule simply permitted the seller to exclude up to $250,000 ($500,000 on a joint return) of the gain on the sale. Any excess above these amounts would be currently taxable at the capital gains rate for the year of sale. The reinvestment rules were eliminated, so taxpayers gained mobility and flexibility. The exclusion gives them the ability to downsize, buy more than one property, purchase a non-real estate asset or do anything they choose with the proceeds of the sale. The exclusion is restricted to the sale of only a principal residence, and certain qualifications must be satisfied in order to receive the benefit of the exclusion. As with the MID, the $250,000 and $500,000 amounts are not indexed for inflation.

No data is publicly available that allows either NAR or its consultants to evaluate the impact of possible changes to these rules. No public IRS records present information about Forms 1099 that are filed for home sale transactions, and only limited information on capital gains data are published to show the amount of taxable gain reported on homes sales in certain years. In addition, there is no way to ascertain the value of unrecognized gain that has accumulated in homes that are not currently on the market. Finally, long-term holders are far more likely to have larger appreciation amounts and so should not be penalized for that long tenure.

We note that this provision is among the most taxpayer-friendly sections in the entire code. When enacted, it was a substantial simplification from prior law. Further, it allows a great deal of flexibility in the financial planning for families. Notably, the gain on the sale of a principal residence is a significant factor in the retirement savings plan of many older Americans. They anticipate downsizing and then using the remaining proceeds to supplement any retirement income they have. Prior law penalized individuals over age 55 by limiting an exclusion to just once in a lifetime and with a relatively small amount. Today's rules reflect far more accurately the home ownership patterns over a lifetime. The exclusion functions as a sort of "Housing Roth IRA" in that the gains made over long periods (in many cases with improvements made from after-tax dollars) are free of tax at the time of sale. At a time when policymakers are contemplating changes to entitlement programs and Americans are struggling to save more for retirement, Congress should continue to recognize the important role the principal residence exclusion plays in supplementing retirement savings. NAR urges Congress to retain the exclusion at current levels or secure its importance for future generations of homeowners by indexing it for inflation.

Cancellation of Mortgage Indebtedness for Principal Residence

Under general tax principles, when a lender cancels a portion or all of a debt, including mortgage debt, the borrower is required to recognize the forgiven amount as income and pay tax on it at ordinary income rates. An exception is provided for some mortgage debt that was forgiven between January 1, 2007 and December 31, 2016. When this relief was initially considered in 2007, the Ways and Means Committee reported it as a permanent provision. The final version, however, was temporary and in place only through December 31, 2009. That date was extended through December 2012 as part of the flurry of legislation enacted at the height of the 2008 financial crisis. The American Taxpayer Relief Act of 2012 subsequently extended the expiration date to December 31, 2013, and The Tax Increase Prevention Act of 2014 extended the expiration date to December 31, 2014. The Preventing Americans From Tax Hikes (PATH) Act of December 2015 extended the provision through the end of 2016. However, the provision has not been extended this year.

While the volume of short sales and foreclosures has receded from record highs, there are still a significant number of families struggling to keep up with their mortgage payments and banks are still working to conduct loan modifications as a result. Moreover, the vicious hurricanes that have wreaked such damage on so many U.S. counties this month and last have greatly exacerbated the problem.

NAR believes the tax code should not discourage homeowners from trying to take proactive steps to avoid foreclosure by taxing them on phantom income, especially when the Federal Government has devoted considerable resources to help modify mortgages and lessen the impacts of foreclosure.

We urge the Finance Committee to make mortgage cancellation relief a permanent provision.

SECTION 1031 LIKE-KIND EXCHANGES

Finally, NAR strongly believes that the like-kind exchange provision in current law is vital to a well-functioning real estate sector and a strong economy and must be preserved in tax reform. The like-kind exchange is a basic tool that helps to prevent a "lockup" of the real estate market. Allowing capital to flow more freely among investments facilitates commerce and supports economic growth and job creation. Real estate owners use the provision to efficiently allocate capital to its most productive uses. Additionally, like-kind exchange rules have allowed significant acreage of environmentally sensitive land to be preserved.

Section 1031 is used by all sizes and types of real estate owners, including individuals, partnerships, LLCs, and corporations. The committee might be surprised to learn that a large number of like-kind exchange transactions involve single-family housing. To illustrate, a recent survey of our members indicated that 63 percent of Realtors have participated in a 1031 like-kind exchange over the past 4 years.[17]

A 2015 study[18] found that in contrast to the common view that replacement properties in a like-kind exchange are frequently disposed of in a subsequent exchange to potentially avoid capital gain indefinitely, 88 percent of properties acquired in such an exchange were disposed of through a taxable sale. Moreover, the study found that the estimated amount of taxes paid when an exchange is followed by a taxable sale are on average 19 percent higher than taxes paid when an ordinary sale is followed by an ordinary sale.

If one of the goals of tax reform is to boost economic growth and job creation, any repeal or limitation of the current-law like-kind exchange provision is a step in the wrong direction.

CONCLUSION

NAR thanks the Committee on Finance for inviting our input into this important hearing. Improving our tax system is an important and worthy goal, and we commend you for taking on this gargantuan and often thankless task.

The residential real estate market is a significant driver of the American economy. When housing does well, America does well. Our Nation has been led out of

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[17] "Like-Kind Exchanges: Real Estate Market Perspective 2015," National Association of Realtors, *https://www.nar.realtor.*

[18] "The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate," David C. Ling and Milena Petrova, March 2015, revised June 22, 2015.

four of the last six recessions by a recovery in the housing market and housing gains over the past several years are an important part of the sustained recovery.

Despite the price declines, foreclosures, and economic hardship that haunted the housing market during the Great Recession, Americans remain committed to the ideals and vision of home ownership. They continue to hold the vast majority of their personal wealth in their homes. They continue to believe that ownership of real property is a vital part of the American Dream that was envisioned from the very beginning by our Founders. This is why even high numbers of those who now rent their home consistently support tax incentives for home ownership and aspire to own themselves someday. Congress should not turn its back on these same ideals as it seeks to reform our tax system.

QUESTIONS SUBMITTED FOR THE RECORD TO IONA C. HARRISON

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

STATUS QUO?

Question. Ms. Harrison, reading over your testimony, I was struck by the numerous defenses of the status quo. Does the National Association of Realtors support tax reform? If so, do you have any specific suggestions on what could be reformed about our Nation's tax laws?

If the tax laws are exactly the way they should be, that would be helpful to know.

Answer. The National Association of Realtors does believe that our current tax system contains many flaws and is badly in need of thoughtful and careful reform. The Internal Revenue Code is too complex and includes many provisions that can work at cross-purposes with each other. And even some provisions that have greatly simplified the tax lives of millions of taxpayers and assist millions more in saving for retirement, such as the exclusion of gain on the sale of a principal residence, need to be improved by indexing their limits to inflation. Otherwise, they will continue to grow less beneficial every year. If it does nothing else, a good tax reform act should protect the benefits it provides from the ravages of inflation.

Also, our economy could doubtless benefit from lowering tax rates in a fiscally responsible way. Economic growth is important, and our tax laws should promote and not hinder growth and job creation. This is a principal reason NAR is sensitive to careless tax reform that can damage, rather than propel, economic growth. The Tax Reform Act of 1986 included some harsh and, in our view, unwarranted provisions that sent the commercial real estate sector reeling for more than a decade and caused untold economic harm to many in the Nation. Our position on tax reform is very clear—responsible reform is important but a paramount goal is that it should first, do no harm.

PERCENT OF ITEMIZERS

Question. Ms. Harrison, in your written testimony you state Congress set the standard deduction in 1944, and again in 1969, so that 82% of taxpayers claimed the standard deduction, and only 18% of taxpayers itemized.

According to your testimony, currently approximately 33% of taxpayers itemize, and 67% of taxpayers claim the standard deduction.

Given the precedent of targeting 82%, should Congress again target having only 18% of taxpayers itemize their deductions? What do you believe the ideal percentage of taxpayers claiming the standard deduction to be?

Answer. The standard deduction has been an important tool in simplifying the tax lives of millions of people. However, it must be recognized that the goal of simplification must be balanced with the incentive effect of the present-law itemized deductions as well as the economic effect of making sudden and large changes to long-standing tax policy. Also, there are tax equity implications to large changes in the standard deduction.

In terms of simplification, greatly increasing the standard deduction would significantly decrease the number of itemizing tax filers. The authors of the House Republican tax reform Blueprint estimate that only about 5 percent of filers would still be itemizing after the increase outlined in that plan. However, this does not mean that 95 percent of filers could simply forget about the complexities and time-consuming problems of dealing with Schedule A of Form 1040. Tens of millions of information returns would still need to be prepared, sent to, and dealt with by taxpayers with a mortgage or those who made charitable contributions, and these filers would still need to consider whether to itemize, even if most of them did not.

More importantly, the huge increase in the standard deduction would sap the incentive value of the mortgage interest deduction for the vast majority who now claim it, as it would no longer make a difference on their tax return whether they owned a home or were renting one. Along with this (and also due to the proposed repeal of the property tax deduction), home values would most likely drop significantly, causing untold harm to homeowners everywhere, and especially to first-time buyers, who very often have small amounts of equity in their home. This would almost certainly have serious and negative macroeconomic effects.

Also, as I indicated in my written testimony, the standard deduction represents a tax giveaway to everyone who claims it, and the higher the amount of the standard deduction, the greater the giveaway. While this effect is a not a regressive one, it is important that policymakers are aware of its effect. Deductions such as that for mortgage interest offer a strong incentive to take the specific action of taking out a mortgage by purchasing a home. Giveaways through a higher standard deduction dis-incentivize taxpayers by rewarding all whether the desired action is taken or not.

As to an ideal percentage of taxpayers claiming the standard deduction, I will simply note that a major stated reason that Congress has increased the standard deduction in the past has been because inflation eroded the standard deduction. Since the standard deduction has been indexed for inflation, this has become much less, if any, of a problem. Thus, a major driver of standard deduction increases in the past is no longer present.

Finally, I will note that if Congress wanted to install into the tax code many of the benefits of a higher standard deduction without the disadvantages of diluting the incentive value of itemized deductions, it could do so by once again creating a true zero bracket amount in the tax law.

FLUCTUATION OF TAXPAYERS IN THE WEALTHY CATEGORY

Question. Ms. Harrison, your testimony includes the following observation: "Even though the percentage of taxpayers who itemize has remained relatively constant over the past 25 years, the individuals who comprise the universe of itemizers changes from year to year." And you also observe that: "In short, circumstances change."

I think that those are accurate observations. A person who takes one or more itemized deductions today is in a different situation tomorrow or years from now and years earlier. It is also true, when we look at things like capital gains or someone's place in the income distribution, that the person who receives a capital gain today or resides in a certain income category today may not be in the same position yesterday or tomorrow. That is, circumstances change, which I think is important to consider, and something that analysts often don't consider as much as they should.

Stated another way, it is important to keep in mind that some people who look like they are part of the so-called "rich" today may only be so temporarily, and not in a perpetual state of "richness."

I wonder if you agree.

Answer. Yes, I do agree. One of the most important benefits of the mortgage interest deduction is that it is there to assist those first-time home buyers who are facing the early years of mortgage payments when interest makes up a much higher proportion of the monthly payment. As the mortgage is amortized, families often become more financially stable, and the extra assistance of the mortgage interest deduction is not as needed. This is why many millions of homeowners do not claim the MID in any particular year. They have either paid off, or significantly paid down, their mortgages. The number of homeowners who, at some point over their ownership of the home, have utilized the deduction is a much more accurate measure of the importance of the deduction in encouraging home ownership.

TRANSITION POLICY

Question. Ms. Harrison, I agreed with your point that: "If one were designing a tax system for the first time, one would likely devise something that is different from what we have already."

You then went on to state that some provisions in the tax code have been around for over a century, and thus many asset prices have the expectation of those tax provisions continuing.

So, what are your thoughts on transition policy. Namely, it's certainly true we don't want, through tax law changes, to create tremendous upheaval, even if the new law will be more efficient in the long run. Your thoughts?

Answer. As mentioned above, Realtors believe that tax reform is important and needed, but should first, do no harm. This may sound like little more than a slogan, but your question brings to light the reality of the harm that careless tax reform can do to those who reasonably relied on the tax law when making decisions.

When homeowners (or any taxpayers) enter into a major transaction, such as purchasing a home, they rely on the current law staying in place over the life of that transaction. Having the tax law subsequently change in an adverse way can greatly affect the ongoing investment in a very negative and unfair manner.

Please let me mention just three examples in the home ownership arena that could have serious or severe consequences on those who, in good faith, purchased a home in reliance of the current tax law continuing to provide the benefits available at the time of the transaction.

First, consider the first-time home purchaser who, like the majority of those entering the ranks of home ownership, has only a minimal amount for the down payment, say less that 10 percent. If the tax law is suddenly changed to where the expected tax benefits are no longer available, the value of the investment (the home) will drop, and the taxpayer's relatively small amount of equity in the home could completely disappear, leaving the mortgage under water, meaning the home is no longer worth as much as is owned on the loan. We have only to look at the experiences of many homeowners during and following periods of economic downturn to find examples of the disruption and pain that can be inflicted.

Second, take the case of a family with college-bound children. Many parents of college students turn to the equity in their homes to help cover the high costs of higher education for their children. Negative changes in the tax rules that provide tax benefits of owning a home could adversely affect the ability of these families to provide for that higher education.

Finally, please consider the case of the tens of millions of the Baby Boom generation who purchased a home some time ago and have been building equity in that home. As these homeowners approach retirement age, they are planning and relying on the equity of that home to be there to assist in financing those retirement years. For many, their home will be their largest retirement asset. Changes in the tax law that reduce that equity can have serious consequences to retirement plans when there is little time to recover from the reduction in savings.

In short, major adverse changes in tax policy that occur after important transactions have been entered into, can and will adversely affect families who have responsibly relied on those tax benefits being there for the duration of their investment. Taking them away is unfair and will cause harm.

QUESTIONS SUBMITTED BY HON. ROBERT MENENDEZ

Question. Ms. Harrison, in your testimony you argue that the value of the mortgage interest and property tax deductions is already baked in to the price of a home, and that if these deductions were repealed or reduced, the price of homes would diminish.

Could you point to any empirical evidence that guides your views?

Answer. Economists have long acknowledged that the mortgage interest and property tax deductions are included in the value of homes. Most recently, the National Association of Realtors commissioned a study of the estimated impact of a Blueprint-type tax reform plan from a prominent national firm. The study estimates that home prices in the short run would fall by 10.2 percent as a result of this kind of tax reform. The effects would likely be higher in higher cost areas. Please see the study at *http://narfocus.com/billdatabase/clientfiles/172/21/2888.pdf.*

Question. Ms. Harrison, you have a wealth of experience in the real estate business and have seen the real world implications of tax policy.

Can you tell us how your experience has influenced your views on the mortgage interest deduction? Has the MID and property tax deductions really made a difference for the clients you have worked with?

Do you really think diminishing these deductions would harm the rate of home ownership?

Answer. For many Americans, the purchase of a home is the single most expensive purchase they will ever make. The decision to purchase a home is influenced by a variety of factors, which differ from family to family and is rarely just based on financial factors. Nevertheless, the ability to purchase is a financial decision. For many of the customers and clients with whom I have worked, the deductibility of SALT and the MID have made the difference that allowed them to purchase a home. For this reason, I believe that home ownership rates would drop in my market area, Prince George's County, MD, if these deductions were diminished or eliminated.

Question. Ms. Harrison, critics of the MID and SALT argue that doubling the standard deduction will eliminate any additional burden caused by repealing these itemized deductions.

What is wrong with this line of thinking? Wouldn't everyone still be able to claim as much of a deduction as they can now?

Answer. There are at least two problems resulting from the actual repeal of the SALT deduction and the almost de-facto repeal of the MID under the kind of tax reform being discussed. The first, as I mentioned above in my answer to the chairman in his question about the percentage of itemizers, is that these changes would greatly diminish the incentive value of these two deductions for homeowners. This will make it much harder for many first-time homebuyers to make the move from renting to owning and also sap the equity of tens of millions of homeowners.

The second problem is that the increase in the standard deduction is not a true increase, but a substitution of the personal and dependency exemptions, which would be repealed under the tax reform plans we have seen promoted this year. This means that the purported increase in the standard deduction is not a true increase in the exemption amount. For some taxpayers, particularly single ones, there would still be an increase in the amount of income that is exempted from tax. And many or most of these would indeed receive a tax cut from tax reform. For other filers, and particularly those with children, the amount of income exempted from tax as a result of the increase in the standard deduction combined with the repeal of the exemptions would go down, not up. Some of these filers would get relief from this effect by the higher tax credit for children that is promised as part of the reform plan. However, among those taxpayers with larger families, and especially those with children over the age of 16 or with incomes too high to qualify for the child tax credit, there will be many millions who pay more taxes because the amount of the repealed exemptions is higher than the increase in the standard deduction.

Question. Ms. Harrison, beyond the economics, what about the impact home ownership has on society?

Why should the tax system encourage home ownership?

In your experience as a Realtor, does our society benefit through greater home ownership? If so, does this benefit justify the value of tax incentives for home ownership?

Answer. Home ownership remains a goal for most American families, and with good reason. It creates communities that are stable and vibrant and is one of the chief sources of wealth building for middle-class families. The provisions in the tax code that have favored home ownership are an acknowledgement of the high value our society places on home ownership and the communities it creates.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. What metrics or considerations should Congress use to determine appropriate trade-offs in tax reform?

Answer. Tax reform can mean many different things to different people. For example, a tax reform plan that has as its goals to provide a tax cut for the middle-class should actually deliver those results. Likewise, a tax reform that promises increased prosperity through higher economic growth should not result in many billions of lost equity in the first years after its passage. One of the main messages NAR has tried to communicate with Congress about tax reform is that it is important to accomplish thoughtful tax reform, but first, it should do no harm.

Question. How would you suggest Congress address the skyrocketing cost of rental housing? Please provide some specific ideas to consider.

Answer. Realtors have long supported the current-law Low-Income Housing Tax Credit, which has been remarkably effective in incentivizing the construction and rehabilitation of low-income housing units since its inception in the 1986 Tax Reform Act. The National Association of Realtors is part of the "A Call To Invest in Our Neighborhoods (ACTION) Campaign," a national coalition representing over 2,000 national, State, and local organizations and businesses advocating to preserve, strengthen and expand the Low-Income Housing Tax Credit (Housing Credit).

The Coalition is urging Congress in tax reform to ensure that the value of the Low-Income Housing Tax Credit is not diminished through the reduction in the corporate income tax rate and that the Credit is improved in various other ways. More information about specific recommendations can be found here: *http://rentalhousingaction.org.*

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 on ways to streamline the individual tax system to make it work better for American individuals and families.

Welcome everyone to this morning's hearing, where we will discuss a major piece of the tax reform puzzle. Today we'll be talking about ideas, proposals, and considerations for reforming the individual tax system.

While we have had countless hearings on tax reform in recent years, today's hearing is the first in what I hope will be a series of hearings leading up to an intensive effort on this committee to draft and report comprehensive tax reform legislation.

We've talked about these issues a great deal. In fact, since I became the lead Republican on this committee in 2011, we've had more than 60 hearings where tax reform was a main focus of the discussion. I think we're capable and ready to get to work on producing a bill, and I look forward to working with my colleagues on this next, all-important stage of the process.

I'd like to make a couple points about that process for a moment, because there seems to be some confusion as to what the Finance Committee's role will be in tax reform.

I've heard a lot of talk about a secret tax reform bill or a comprehensive plan being written behind closed doors. Most of you have probably also heard about tax reform details that are set to be released later this month.

True enough, leaders in the House and Senate, including myself, as well as officials from the executive branch have been discussing various proposals. But, as we stated in our joint statement before the recess—and as I have stated on numerous occasions—the tax-writing committees will be tasked with writing the bill. The group—some have deemed us "The Big Six"—will not dictate the direction we take in this committee.

Any forthcoming documents may be viewed as guidance or potential signposts for drafting legislation. But, at the end of the day, my goal is to produce a bill that can get through this committee. That takes at least 14 votes, and hopefully we'll get more. Anyone with any experience with the Senate Finance Committee knows that we are not anyone's rubber stamp. If a bill—particularly on something as consequential as tax reform—is going to pass in this committee, the members of the committee will have to be involved in putting it together.

Therefore, I intend to work closely with my colleagues and let them express their preferences and concerns so that, when we are ready to mark up a tax reform bill, the mark will reflect the consensus views of the committee. That work, in many respects, has already begun.

I'll note that I have not limited these commitments to my Republican colleagues on the committee, which brings me to my second point.

From the outset, I have made clear that my preference is to move tax reform through this committee with bipartisan support. I have no desire to exclude my Democratic colleagues from this discussion, and I'm not determined to report anything by a party-line vote.

I'll note that the President and his team have publicly said the same thing this week.

If any of my Democratic colleagues are willing to come to the negotiating table in good faith and without any unreasonable preconditions, I welcome their advice and input.

So far, my colleagues have insisted that the majority agree to a series of process demands before any substantive bipartisan talks can take place. Effectively, they want to ensure that we make it easier for them to block the bill entirely before they'll talk about what they want to put in the bill.

That seems counterintuitive to me. And, in my view, it is unreasonable. Furthermore, I don't recall the other side ever offering such a concession when they were in the majority.

We should not let process concerns keep us from talking about the substance of a tax reform bill. My hope is that my colleagues on the other side will put these demands aside and let us begin searching for common ground on these important issues.

Those threshold matters aside, let me talk about today's hearing.

One argument that rears its ugly head in every tax reform debate is the claim that proponents of reform want to cut to taxes for the uber-rich and give additional tax breaks to greedy corporations.

We've heard that argument repeated in the current debate. While these claims are about as predictable as the sunrise, they are simply not true.

While I can't see into the hearts of every member of Congress, I truly don't know of a single Republican who, when thinking about tax reform, asks themselves what they can do to help rich people. That has never been our focus, and it is not our focus now.

Instead, we are focused squarely on helping the middle class, and recent proposals to reform the individual tax system reflect that.

For nearly a decade now, middle-class families and individuals have had to deal with a sluggish economy, sub-standard wage growth, and a growing detachment from labor markets.

Tax reform, if it's done right, can help address these problems and provide much-needed relief and opportunity for millions of middle-class families. That, once again, is our goal in tax reform—it is, in fact, a driving force behind our efforts.

Let's talk about a few specific proposals.

Under our tax code, individual taxpayers or married couples can opt to either take the standard deduction or itemize deductions to lower their tax burden. Currently, about two-thirds of all U.S. taxpayers opt to take the standard deduction. These are often low-to-middle income taxpayers.

One idea that has been central to a number of tax frameworks is a significant expansion of the standard deduction, which would reduce the tax burden for tens of millions of middle-class families and eliminate Federal income tax liability for many low- to middle-income Americans.

I'll note that this is not only a Republican idea. In fact, a few years back, our ranking member introduced legislation that would have nearly tripled the standard deduction.

This is the very definition of middle-class tax relief, and it goes beyond direct tax and fiscal benefits.

With a significantly expanded standard deduction, the tax code would immediately become much simpler for the vast majority of middle class taxpayers. And that is no small matter.

Currently, American taxpayers—both individuals and businesses—spend about 6 billion hours and nearly a quarter of a trillion dollars a year complying with tax filing requirements. This, of course, is not surprising given that our tax code has grown exponentially into a three-million-word behemoth that is basically indecipherable for the average American.

That one change—expanding the standard deduction—would let millions of middle-class taxpayers avoid having to navigate the treacherous landscape of credits and deductions. Combined with other ideas, including a significant reduction in the number credits and deductions in the tax code and a radically simplified rate structure, this approach will save middle-class families both time and money.

I expect there to be some disagreements about what credits and deductions to keep and which to repeal in the name of tax simplicity, efficiency, and fairness. I expect we'll air some of those differences of opinion here today.

There are other tax reform proposals under discussion that will help the middle class.

For example, an increase and enhancement of the Child Tax Credit would benefit middle- and lower-income families almost exclusively.

And, by reducing barriers and disincentives for savings and investment, we can expand long-term wealth and improve the quality of life for those in the middle class.

These are some of the central ideas being discussed to reform the individual tax system. And, in virtually every case, the primary beneficiaries of these proposals would be middle-class taxpayers.

I know that there are Democrats who support these types of reforms. As I mentioned earlier, I hope we can recognize this common ground and find ways to collaborate in the broader tax reform effort.

I'll also note that the middle class has a significant stake in our efforts to reform the business tax system. But, that is a matter for another hearing.

Once again, this committee has a lot of work to do. There is not going to be a top-down directive that makes the hard decisions for us. I know we're up to the task and that most of us are game to participate in the process to help us reach a successful conclusion.

Before I turn to Senator Wyden, I want to say that I hope we can have a productive discussion of options to reform taxes for individuals, and not a debate on so-called "plans" based on outside analysts' conjectures and assumptions. It is all too common for ideological think tanks and partisan analysts to take short statements outlining broad principles on tax reform and then fill in the gaps with their own subjective assumptions about details just to parade out a list of horribles that they then use to tarnish the entire reform effort.

Let us discuss real ideas and proposals, keeping in mind that the Finance Committee will not be bound by any previous tax reform proposal or framework when we start putting out bill together.

PREPARED STATEMENT OF RAMESH PONNURU, VISITING FELLOW, AMERICAN ENTERPRISE INSTITUTE

Chairman Hatch, Ranking Member Wyden, and distinguished members of the Finance Committee, thank you for convening this hearing on "Individual Tax Reform." I am a visiting fellow at the American Enterprise Institute, a senior editor at *National Review,* and a columnist for *Bloomberg View.* This testimony reflects my own views and not those of any organization with which I am affiliated. It is an honor to be testifying before you.

While tax policy has been a politically contentious issue, over the last 20 years a broad political consensus has supported tax relief for parents of dependent children. The major reforms of the tax code undertaken over this period have consistently included such tax relief. The Taxpayer Relief Act of 1997 instituted a tax credit of $500 per eligible child. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the amount of the tax credit to $1,000. The Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the phase-in of that expansion. And the American Tax Relief Act of 2012 made that expansion permanent.

People on different parts of the political spectrum have had varying reasons for supporting the child credit, including an appreciation of the costs of raising children and the belief that raising children is, in no merely metaphorical sense, an investment in the Nation's future. The fact that the child credit lifts nearly 3 million people out of poverty each year has also brought it support.[1]

Yet the child credit has had critics, who believe that it represents a form of governmental favoritism or even "social engineering," and that changes to the tax code should consist of measures more directly related to increasing economic growth.

In this testimony I will lay out a case for expanding the child credit—specifically, for increasing the maximum level of the credit and for applying it to reduce payroll-tax as well as income-tax liability—as a crucial component of tax reform.

REDUCING THE "PARENT TAX"

The main goal of tax reform is generally taken to be to move closer to a tax code that raises the desired amount of revenue while minimizing the distortions that government policy can create. One example of a distortion caused by government policy is an unjustified tax break for a particular kind of investment. This departure from neutrality between different types of economic activity has two negative effects. It unfairly transfers resources from one group of people to another, and it reduces the efficiency with which markets direct capital to its most productive uses. In that way the tax break reduces national welfare and eliminating the break would increase it. Another example of a distortion: in theory, high tax rates on income can so discourage work that reducing them raises the same amount of revenue while allowing for a larger economy.

One rationale for an expanded tax credit for children is that it reduces a distortion caused by government policy: the large, though implicit, tax on parenting that the structure of our entitlement programs has inadvertently created. Social Security and Medicare, our principal government programs to take care of senior citizens, rely for their financing, in large part, on parents. All taxpayers, whether or not they have children, contribute to the program. Parents, however, contribute to the program both through the Federal taxes they pay and through the financial sacrifices they make to raise children (including, in many cases, forgone income). The Federal Government does not recognize the extent of this contribution, which has the effect of causing parents to shoulder a larger share of the burden of government than they should.

Consider two couples with similar earnings histories, one with two children and one with none. The first couple contributes more to the future of the entitlement programs but gets no more benefits from those programs as a result. In the world before the entitlement State, many of the financial sacrifices the first couple made in raising children would redound to their direct benefit in old age, as their children took care of them. Entitlements socialize much of the financial return from child-rearing for the betterment of senior citizens as a group, regardless of whether or how many children those senior citizens have.

Society has made this choice for weighty and very widely supported reasons. But if it does not recognize parental investment in children as a contribution to the entitlement programs, it is, whether it consciously aims to do so or not, transferring resources from parents to the childless and from larger families to smaller ones. We can call this transfer the "parent tax."[2]

Two mistaken objections to this analysis may suggest themselves. The first is that it is a kind of single-entry bookkeeping, since most of those children will grow to be senior citizens one day and then benefit from Social Security and Medicare themselves. In the past, I have suggested a thought experiment to illustrate why that's a mistaken view.[3] Imagine a society with old-age programs similar to ours in which for generations each woman has had two children. Imagine next that for one generation each woman has three children, and then the pattern of two children re-asserts itself. That increase in the number of children would work an improvement in the finances of the programs that would never be undone. For one generation, the same

[1] "Policy Basics: The Child Tax Credit," Center for Budget and Policy Priorities, October 21, 2016.

[2] Large transfers of this kind can also be expected, all else equal, to reduce by some amount the number of children that people raise. For evidence that this effect has occurred in developed countries, *see* Michele Boldrin, Mariacristina De Nardi, and Larry E. Jones, "Fertility and Social Security," NBER Working Paper no. 11146, February 2005; and Isaac Ehrlich and Jinyoung Kim, "Social Security, Demographic Trends, and Economic Growth: Theory and Evidence from the International Experience," NBER Working Paper no. 11121, February 2005.

[3] Ramesh Ponnuru, "The Empty Playground and the Welfare State," *National Review,* May 28, 2012.

tax rate would yield a higher level of benefits. Afterward that society could revert to the previous benefit level, but it would never have to go below that level. (Alternatively, that society could react to its baby boom by keeping benefits flat and for one generation reducing tax rates.)[4]

The second mistaken objection is that this analysis omits the many government benefits that accrue to families with children. Childless adults pay for schools through their taxes, after all. The difference is that all of these childless adults benefited themselves from an education financed by someone else. A system of general taxation to pay for schooling does not create free riders in the way Social Security and Medicare do, and does not represent a transfer from smaller families to larger ones.

Other government policies, however, represent genuine but very partial offsets to the parent tax: notably the tax exemption for dependents and the existing tax credit for children. The problem is the scale: these policies reduce the parent tax but leave it still quite high. One conservative estimate suggests that the child credit would need to increase to roughly $4,800 per child to eliminate it completely.[5]

While a large child credit is not the only way to reduce the parent tax, it has significant advantages over other methods. An alternative that has been proposed is to reduce payroll taxes based on the number of children a taxpayer is raising.[6] Benefit levels in retirement could also be set to vary based on the number of children a senior citizen had raised. A larger child credit would, however, be administratively simpler than either policy, since it would only change an existing provision of the tax code. Compared to a higher-benefits policy, it would also direct resources to households at the time they are most likely to be needed: that is, when they are raising children.[7]

A larger deduction for the cost of commercial day care, meanwhile, would reduce the parent tax for some families but exclude the many families who make different arrangements for their children.

An increased standard deduction has also been proposed as a way to deliver tax relief to middle-class Americans. Whether or not this increase would be desirable on other grounds, it would not reduce the parent tax. It appears that more of the benefits of a child-credit expansion would also accrue to relatively low-income households.[8]

APPLYING THE CHILD CREDIT AGAINST PAYROLL TAXES

The logic of this case for a large child credit does not just militate in favor of raising its maximum value from $1,000 per child to some bigger number. It also militates in favor of applying it against payroll taxes as well as income taxes: in favor, that is, of making it partially "refundable."

The parent tax arises, again, because parents are contributing to Social Security and Medicare both through their taxes—including especially their payroll taxes—and through the financial sacrifices they make to raise children. If we wish to reduce their contributions to put it on par with those of non-parents, we need to take account of the payroll taxes as well as the income taxes. Consider once more our two couples, one with children and one without, and assume both of them are pay-

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[4] The thought is developed in Hans-Werner Sinn, "The Value of Children in a Pay-As-You-Go Pension System: A Proposal for a Partial Transition to a Funded System," National Bureau of Economic Research Working Paper 6229, October 1997.

[5] Robert Stein, "Taxes and the Family," *National Affairs,* Winter 2010. I have updated his estimate using the Consumer Price Index.

[6] Charles Blahous and Jason J. Fichtner, "Limiting Social Security's Drag on Economic Growth: Removing Disincentives to Personal Savings and Labor Force Participation," Mercatus Research, 2012.

[7] Shrinking the entitlement programs would also reduce the parent penalty, although that proposal would of course involve important trade-offs beyond the scope of this testimony. The programs would have to be very drastically reduced, however, to eliminate the parent tax entirely. *See* Hans-Werner Sinn, "The Pay-As-You-Go Pension System as a Fertility Insurance and Enforcement Device," National Bureau of Economic Research Working Paper 6610, June 1998.

[8] The Tax Foundation estimates that a doubling of the standard deduction would reduce revenue by $1.3 trillion over 10 years while raising incomes in the second-lowest-earning quintile of taxpayers by 0.15 and 1.4 percent; doubling the child credit would on the other hand reduce revenue by $640 billion over 10 years while raising income in the lowest quintile by 0.5 percent and the second-lowest quintile by 2.1 percent. "Options for Reforming America's Tax Code," Tax Foundation, 2016.

ing the same amount of payroll taxes but do not make enough money to have income-tax liability. The former couple should have a lower payroll-tax liability.

Not only that: The credit should in principle be applied not just against "employee-side" payroll taxes but against "employer-side" payroll taxes as well. It is widely recognized among economists that the taxes an employer pays toward Social Security and Medicare for employees represent forgone wages.[9] Their true economic incidence, that is, falls almost entirely on the worker. They, too, are thus part of the contribution that the taxpaying employee makes to these programs.

Some observers have expressed concern about taking people off the income tax rolls. The child credit has already kept some families from having a positive income-tax liability and an expanded child credit would have that effect for even more families—and, as we have seen, reduce their payroll-tax liability too. These observers worry that voters who do not pay taxes will have an unhealthful relationship to government, seeing its benefits as free. The empirical grounding for this fear is weak, however, and in any case a household's removal from the tax rolls will be temporary: Adults will lose the credit when their children grow up. And if any large group of citizens can be expected to look to the future, it should be parents.

PAYING FOR AN ENLARGED CHILD CREDIT

As with any form of tax relief, a larger child credit would require the government either to tolerate larger deficits, to reduce spending, or to raise other taxes. It is possible to agree on the case for a larger child credit while disagreeing on many of these questions of fiscal and tax policy. My own top preference would be to reform Social Security and Medicare in ways that would reduce the Federal Government's long-term spending compared to their projected levels while also maintaining and perhaps even augmenting our current commitments to the neediest.[10] My second preference would be to scale back or eliminate tax breaks such as the deductions for mortgage interest and State and local taxes, especially for the highest earners. A third solution would be to lower the thresholds at which people move into the highest tax brackets, so that the top marginal tax rates in a reformed tax code apply to a larger number of people.

My main point in this testimony, however, is to argue that reducing the parent tax ought to be a priority for tax reform. If tax reform aims to keep revenues flat, then it should expand the child credit somewhat and make revenue-raising tax policy changes to compensate. But the increase in the credit cannot be wholly paid for by eliminating the dependent exemption, since that would leave the parent tax unaffected.[11] If tax reform instead aims for lower revenues than currently projected, then a larger child credit should account for some of that reduction. An expanded tax credit for children should be part of any larger tax reform that Congress enacts, so that the reform is both pro-growth and pro-family.

QUESTIONS SUBMITTED FOR THE RECORD TO RAMESH PONNURU

QUESTION SUBMITTED BY HON. ORRIN G. HATCH

FUNDING THE CHILD TAX CREDIT

Question. Mr. Ponnuru, you suggest a much higher Child Tax Credit. As you acknowledge, this will cost a lot in the 10-year-window. And so, in the 10 years, this would be difficult to pay for.

But, I suppose one of your points is that it will significantly pay for itself in the long run? That is, today's children will be tomorrow's Social Security taxpayers? If, rather than using a 10-year budget window, Congress used a budget window with an infinite horizon, do you have thoughts on how your proposal might score?

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[9] *See,* for example, Jonathan Gruber, "The Incidence of Payroll Taxation: Evidence from Chile," National Bureau of Economic Research Working Paper 5053, March 1995.

[10] *See* Andrew Biggs, "A New Vision for Social Security," *National Affairs,* Summer 2017, for an example of a proposal that seeks these goals.

[11] Eliminating the dependent exemption and raising the child credit by $600 per child, for example, may be a good idea for reasons unrelated to the parent tax. But it would do nothing to provide tax relief for the many parents in the 15-percent tax bracket—since the lost value of the exemption would cancel out the expansion of the credit—and would therefore not reduce the parent tax they pay.

Answer. The rationale for an expanded child credit is rooted in fairness: the current system overtaxes parents relative to non-parents, and large families relative to small ones. An enlarged tax credit might also change behavior in some cases, however, by making a larger family more affordable. To the extent the policy enables larger families, it will, over a long enough time horizon, partially recoup its costs.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. In your opinion, did the 1986 Tax Reform Act solve the problems it was intended to fix? If so, please provide some examples of how. If not, why?

Answer. The Tax Reform Act of 1986 had both positive and negative features. On the positive side of the ledger, I would place the reduction of marginal tax rates for individuals; the expansion of the Earned Income Tax Credit and personal exemption; the elimination of real estate tax shelters; and the simplification of the tax code. On the negative side, I would place the lengthening of depreciation schedules, the restrictions on IRAs, and the increase in capital gains tax rates. Overall I would say the reform was better at simplifying the code, albeit temporarily, than at promoting economic growth.

Question. President Trump has said he wants to lower the top business tax to 15 percent. Do you believe this can be done without significantly adding to the deficit? If so, please provide a potential scenario for deficit-neutral tax reform in detail (with budget estimates).

Answer. I do not believe the corporate tax rate can be brought to 15 percent without reducing revenues significantly. Unless spending were cut or other taxes raised, the deficit would therefore rise significantly.

Question. What metrics or considerations should Congress use to determine appropriate trade-offs in tax reform?

Answer. I believe the tax code should be designed so as to raise whatever level of revenue Congress deems appropriate in the least damaging manner possible. Among the types of harm Congress should strive to avoid are reductions in the incentives to work, save, and invest; favoritism toward some kinds of economic activity over others; tax bills that are too high, especially on low earners; and tax burdens on parents that are unfairly high.

As you suggest, there are unavoidable trade-offs: raising revenues inevitably reduces incentives to work, save, and invest. For a given level of revenue, leveling the playing field for families (through an expanded child credit) means accepting slightly worse incentives to work, save, and invest (through lower marginal tax rates). There is no formula for making these trade-offs. I believe tax reform should make improvements on multiple fronts rather than focusing on only one of them single-mindedly.

Tax reform should, that is, reduce the tax code's favoritism toward some economic activities over others; improve incentives to work, save, and invest; and offer tax relief to families; all while raising needed revenues.

Question. Do you believe Congress should consider cutting entitlement and safety net programs—like Social Security, Medicare, TANF, and food stamps—to pay for tax reform? If so, why? If not, why not?

Answer. I favor reforms that restrain the growth of Social Security and Medicare. It might be worth considering using some of the budgetary savings to provide additional tax relief. But most reforms would have to be phased in slowly so as to enable people to adjust their retirement plans in advance. Such reforms would accumulate savings too slowly to finance immediate tax relief.

Question. In a recent speech, the President stated: "Our tax plan represents a sharp reversal from the failed policy of the past. America's high tax rates punish companies for doing business in America and encourages them to move to other countries. . . . There has to be a price to pay when that happens; when they let our people go and that happens, and they think they can sell the product right back into the USA. There is going to be a big price to pay, and there has been, and that's why you're seeing a big change." Please provide some suggestions on how the President's tax reform plan could provide a "price to pay" for companies that offshore jobs.

Answer. When a company moves production for the American market outside the United States, it pays various costs, including the cost of transporting those goods and a reduced ability to reap the benefits of productive American labor. I do not believe that government policy should seek to increase those costs. Rather we should make sure that our policies do not impose unnecessary costs on producing goods in America. Lower and fairer taxes on business activity in the United States would make it more attractive to produce here. The "framework" endorsed by President Trump takes many positive steps in this direction.

Question. In your opinion, does a lower tax rate or tax exemption for the foreign earnings of companies that offshore U.S. jobs amount to a "price to pay?"

Answer. No.

Question. One of the President's stated objectives for tax reform is to make the tax code fairer. How would you suggest he achieve this objective?

Answer. The most important way he could achieve this objective would be to put real money behind the "significant" expansion of the tax credit for children that he has already endorsed, and to make sure that some of that money relieves families with low and moderate incomes from their payroll tax liabilities.

Prepared Statement of Hon. Ron Wyden, a U.S. Senator From Oregon

It'd be great if what I'm hearing about the goals for individual tax reform actually lined up with the details of the plans that are reportedly in the works, but that just isn't the case. Not even close.

The President declared to the Nation that his tax plan would not give any breaks to the wealthy. But the fact is, his one-page tax outline has a new, lunar crater-sized loophole for the wealthy allowing them to abuse pass-through status. Pass-through status is supposed to be about helping small businesses, but the Trump plan turns it into a scheme for the wealthy to dodge paying their fair share. That's on top of abolishing the estate tax, which only touches one out of every 500 wealthy estates today. It's another outlandish giveaway to people at the top.

This morning the Finance Committee is going to spend a few hours spinning its wheels while the actual framework of the Republican tax plan is being written behind closed doors. That's not to say the issues that'll be discussed today are unimportant; nobody has invested more sweat equity in tax reform than I have.

But the proposal the committee ought to be evaluating this morning is coming together in secret, written by special interests and it's skipping right past any serious debate or amendment in this room.

And in the meantime, if all you did was listen to the talking points, it'd be easy to think the Republican plan would put a big focus on the burden of complexity the tax code heaps onto so many middle-class families. But the actual architecture of the plan in the works doesn't reduce complexity or focus on the middle class—the Republican plan endows future generations of the mega-wealthy.

There is a blueprint for bipartisan, comprehensive tax reform that works. It's Reagan-style tax reform, and it's not what Republicans are working on today.

Reagan-style tax reform fights complexity by fighting unfairness. Thirty-one years ago, the reform bill President Reagan fought for and signed into law equalized the tax treatment of wages and wealth. That meant that the worker who punched a clock going in and out of every shift wasn't getting a raw deal compared to the fatcats and trust fund babies.

Reagan-style tax reform is also about clearing out the deadwood—the provisions that do a whole lot more to please special interests and lobbyists than they do to create jobs or help families climb the economic ladder.

Those are propositions that I believe ought to get a lot of bipartisan interest again in 2017. That's because the tax code on the books today amounts to a tale of two systems. There's a strict set of rules for the cop and the nurse who are married and raising kids. Their taxes come right out of their paychecks—no special tax dodges or schemes for them to exploit. Then there's another set of rules for the most fortunate. It says they can decide how much to pay and when to pay it.

That's the brand of unfairness that Reagan-style reform would go after. Tax reform in 2017 should be an opportunity to put money back into those cops' and nurses' paychecks, and to help those families save for retirement, pay for college and afford housing.

But the basic proposition that Republicans have on offer goes after middle-class tax benefits like the State and local deduction and incentives for home ownership and retirement savings. And it gores the middle class to finance unprecedented tax handouts for the biggest corporations and the most fortunate.

When it comes to State and local tax deductions, this is fake tax reform. And it's not just a play at taking from blue States. There are middle-class families across the country—taxpayers in deep blue areas that went for Clinton and scarlet red areas that went for Trump—that'll be taxed twice on the same income if State and local deduction is eliminated. The dreaded double taxation—if you're opposed to it when it involves corporate income, you can't line up behind a plan to double tax middle-class families twice on their hard-earned pay.

When it comes to simplification, it's easy to hold up a proposal to double the standard deduction as evidence that you want to make filing easier for a lot of people. But in the recent past I've called for tripling the standard deduction. So the Republican plan for the standard deduction would be a whole lot less generous in that regard.

The basic framework of this plan looks like what you'd put together if you think there are a lot of five-car garages that really need expanding on the middle class's dime. And unfortunately, the administration and Republicans in Congress are committed to the partisan approach. Leader McConnell has said he wants another crack at reconciliation to jam this tax plan through the Senate, and he doesn't want input from Democrats.

So this morning, the committee is going to hear a lot about the complexity of our tax code, the burden on families, and the need to spark economic growth. I am all ears when it comes to ideas centered on those issues—built on giving *everybody* a chance to get ahead the way Reagan-style tax reform did. But the Republican plan I see coming together right now doubles down on the rotten unfairness in our tax code. And that would make it a failure for the middle class and people working to get there.

During today's hearing, I hope the committee is able to take a close look at the real causes of unfairness and complexity, and why going after middle-class tax breaks to fund a tax cut for the wealthy is the wrong approach to reform.

Thank you, Chairman Hatch.

COMMUNICATIONS

ADOPTION TAX CREDIT WORKING GROUP (ATCWG)

July 17, 2017

The Honorable Orrin Hatch
Chairman
Committee on Finance
U.S. Senate

The Honorable Ron Wyden
Ranking Member
Committee on Finance
U.S. Senate

Dear Chairman Hatch, Ranking Member Wyden, and Members of the Senate Finance Committee:

On behalf of the Adoption Tax Credit Working Group (ATCWG), we would like to inform the Committee on Finance of our efforts and offer ourselves as a resource. The ATCWG is a national collaboration of 150 organizations united by our support and advocacy for the adoption tax credit, which plays an important role in encouraging the adoption of children who need families. The organizations that make up the ATCWG represent children and families from every sector of adoption, including U.S. foster care, domestic private, and international adoptions. With our broad representation and involvement in adoption policy and practice issues, we have a unique perspective on the role that the tax credit plays for Americans who adopt.

The ATCWG understands that there is bipartisan interest in simplifying the tax code and we are grateful for your outreach for stakeholder input. As the U.S. Senate Committee on Finance ("Committee") considers the best means of achieving this goal, we urge you to take into account the strong public policy rationale for the adoption tax credit, the broader and longer term cost savings adoption ensures, and the bipartisan history of and support for the credit since its inception.

First enacted in 1996 as a part of the Small Business and Job Protection Act of 1996 (Pub. L. 104–188), the adoption tax credit advances the important goal of enabling domestic and intercountry adoptions, especially for children with special needs who otherwise might linger in costly foster care without the benefits and security of permanent, loving families. **Over 53,000 children were adopted from foster care in fiscal year 2015 alone.**[1] By offsetting some of the costs of adoption or of caring for a child with special needs, the tax credit makes adoption a more viable option for many children and families. **Over 60 percent of adopted children are adopted by lower- and middle-income taxpayers, and almost half of children adopted from foster care live in families with household incomes at or below 200 percent of the federal poverty level.**[2] Congress has always worked across the aisle to prioritize the continuation of the adoption tax credit, and we hope that the Committee will continue to recognize the value of the credit.

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[1] *The AFCARS Report: Preliminary FY 2015 Estimates as of June 2016,* U.S. Department of Health and Human Services: Administration for Children and Families, Adoption and Foster Care Analysis and Reporting System, retrieved July 13, 2017, from: *https://www.acf.hhs.gov/sites/default/files/cb/afcarsreport23.pdf.*

[2] "The Importance of the Adoption Tax Credit," The Adoption Tax Credit Working Group, 2015, retrieved February 18, 2016, from *https://adoptiontaxcreditdotorg.files.wordpress.com/2015/10/atcfactsheet.pdf.*

We applaud the Committee's goal to provide much-needed tax relief to middle-class individuals and families through reforms to the individual tax system. We hope that it will not be forgotten that the adoption tax credit is an existing policy that does just this. It not only provides support directly to lower- and moderate-income families, phasing out for those with higher incomes, but it does so in a way that creates government savings. A study reported by the federal Children's Bureau showed that **the government saves between $65,000 and $127,000 for each child who is adopted rather than placed in long-term foster care.**[3] These savings accrue from reductions in the need for direct child welfare services (foster care and court oversight) and from the long-term societal benefits of adoption (increased graduation rates, reduced homelessness, and reduced incarceration, for example). Annually, over 22,000 youth exit foster care without ever finding a permanent family to help them in the transition to adulthood.[4] An extensive study by Nicholas Zill found that 81 percent of males in long-term foster care had been arrested compared with 17 percent of all young males nationally. Incarceration of former foster youth is estimated to cost society $5.1 billion annually.[5]

Children and youth deserve a permanent family, and while adoption certainly supports these children, it also benefits society broadly.[6] Adoption places children on a path to becoming more productive citizens, and research tells us that poor outcomes are common for youth who exit foster care without stable families. In addition to higher incarceration rates, youth who "aged-out" of the foster care system face many other difficult odds. For example, only 58 percent of foster youth graduated high school by age 19, only 50 percent were employed by age 24, and 71 percent of young women were pregnant by age 21.[7] Studies comparing children who remain in foster care to children who are adopted have shown that: **adopted children are 54 percent less likely to be delinquent or arrested, 19 percent less likely to become teen parents, and 76 percent more likely to be employed.**[8]

As a collective group of diverse organizations, representing thousands of adoptive families across the country and hundreds of thousands of waiting children, one of the goals of the ATCWG is to preserve the adoption tax credit as a part of the individual tax code. As laid out above, the adoption tax credit supports families who desire to adopt and children who deserve a permanent family. However, we would be remiss if we did not bring to your attention the fairness that a refundable tax credit creates for American families.

Some families will never be able to adopt without the benefit of the adoption tax credit. Others will adopt but will not benefit at all, which means they may face challenges meeting their children's needs, particularly children adopted from foster care with special needs.

Over time, Congress has made a series of improvements to the adoption tax credit—the vast majority of which were aimed at addressing the fact that many families who adopted from foster care were not able to claim the credit. Data from 2010 and 2011, when the credit was refundable, shows that for the first time in the credit's history, families who adopted children with special needs from foster care were able to benefit like other adoptive families. While we understand the complex budget and tax issues at hand, failure to maintain this progress will undoubtedly result in more children remaining in foster care rather than moving into permanent families. **There are currently more than 111,000 children in foster care waiting to be**

[3] R.P. Barth, C.K. Lee, J. Wildfire, and S. Guo, "A Comparison of the Governmental Costs of Long-Term Foster Core and Adoption," *Social Service Review* (March 2006), retrieved April 11, 2013, from: *http://www.flgov.com/wp-content/uploads/childadvocacy/foster%20care%20and%20adoption%20study.pdf.*

[4] *The AFCARS Report: Preliminary FY 2015 Estimates as of June 2016,* U.S. Department of Health and Human Services: Administration for Children and Families, Adoption and Foster Care Analysis and Reporting System, retrieved July 13, 2017, from: *https://www.acf.hhs.gov/sites/default/files/cb/afcarsreport23.pdf.*

[5] Zill, Nicholas (2011), "Adoption From Foster Care: Aiding Children While Saving Public Money." Brookings Institute Center on Children and Families, retrieved from *http://www.brookings.edu/~/media/research/files/reports/2011/5/adoption-foster-care-zill/05_adoption_foster_care_zill.pdf.*

[6] Jim Casey Youth Opportunities Initiative (n.d.), retrieved February 3, 2015, from *http://www.jimcaseyyouth.org/.*

[7] Jim Casey Youth Opportunities Initiative (n.d.), retrieved February 3, 2015, from *http://www.jimcaseyyouth.org/.*

[8] Fixsen, A. (2011), "Children in Foster Care Societal and Financial Costs: A Family for Every Child," retrieved from *http://www.afamilyforeverychild.org/Adoption/AFFECreportonchildreninfostercare.pdf.*

adopted,[9] **and this number has increased each of the last three years.** The societal and financial cost of eliminating the adoption tax credit at this time would be especially harmful to waiting children, the families that might adopt them, and the national budget. Alternatively, maintaining or improving the credit, by returning it to refundability, would serve a critical population and eliminate costs related to maintaining youth in less desirable, impermanent foster care as well as costs related to the negative outcomes youth face who age out of foster care without permanency.

As the Committee develops recommendations to overhaul the Internal Revenue Code, we hope that you will consider the ATCWG Executive Committee as a resource for information related to the adoption tax credit. Collectively, we have many decades of adoption experience and a comprehensive understanding of how the adoption tax credit benefits children and is used by families, and we would be pleased to provide any additional information to you and your staff. Thank you for your consideration.

Sincerely,

Adoption Tax Credit Working Group Executive Committee:
American Academy of Adoption Attorneys
Adopt America Network
Christian Alliance for Orphans
Congressional Coalition on Adoption Institute (Secretariat)
Dave Thomas Foundation for Adoption
Donaldson Adoption Institute
National Council for Adoption
North American Council on Adoptable Children
RESOLVE: The National Infertility Association
Show Hope
Voice for Adoption

Adoption Tax Credit Working Group:

Villa Hope	Birmingham	AL
Alabama Foster and Adoptive Parent Association	Cullman	AL
Lifeline Children's Services, Inc.	Birmingham	AL
Dillon Southwest	Scottsdale	AZ
Partners for Adoption	Walnut Creek	CA
AASK—Adopt A Special Kid	Martinez	CA
About a Child	Redwood City	CA
Adoption Law Group	Pasadena	CA
Angels' Haven Outreach	Pleasant Hill	CA
Bal Jagat—Children's World Inc.	Long Beach	CA
Independent Adoption Center	Pleasant Hill	CA
Pact, An Adoption Alliance	Oakland	CA
Across the World Adoptions	Pleasant Hill	CA
Sierra Forever Families	Sacramento	CA
Family Connections Christian Adoptions	Modesto	CA
Bay Area Adoption Services	Mountain View	CA
AdoptFund, Inc.	Los Angeles	CA
Alpine Adoption, Inc.	Lakewood	CO
Adoption Today	Windsor	CO
Project 1.27	Littleton	CO
Fostering Families Today	Windsor	CO
The Adoption Exchange	Aurora	CO
Fund Your Adoption		CO

[9] *The AFCARS Report: Preliminary FY 2015 Estimates as of June 2016,* U.S. Department of Health and Human Services: Administration for Children and Families, Adoption and Foster Care Analysis and Reporting System, retrieved July 13, 2017, from: *https://www.acf.hhs.gov/sites/default/files/cb/afcarsreport23.pdf.*

Adoption Tax Credit Working Group:—Continued

CT Association of Foster and Adoptive Parents	Rocky Hill	CT
Lutheran Services in America	Washington	DC
Families for Private Adoption	Washington	DC
Family Equality Council	Washington	DC
Child Welfare League of America (CWLA)	Washington	DC
Family and Youth Initiative	Washington	DC
Florida State Foster/Adoptive Parent Association	Minneapolis	FL
Broward Foster and Adoptive Parent Association	Plantation	FL
Beacon House Adoption Services, Inc.	Pensacola	FL
Jewish Adoption and Foster Care Options (JAFCO)	Sunrise	FL
Pinellas County Foster and Adoptive Parent Association	Largo	FL
The Adoption Consultancy	Brandon	FL
The Sylvia Thomas Center for Adoptive and Foster Families	Brandon	FL
Georgia Council of Adoption Lawyers	Atlanta	GA
Georgia Association of Licensed Adoption Agencies	Atlanta	GA
Illien Adoptions International, Inc.	Atlanta	GA
Georgia Center for Opportunity	Norcross	GA
Iowa Foster and Adoptive Parents Association	Pleasant Hill	IA
Idaho Foster and Adoptive Parents Association	Post Falls	ID
Family Resource Center	Chicago	IL
Sunny Ridge Family Center	Bolingbrook	IL
The Adoption Lantern	Wilmette	IL
Adoption Learning Partners	Evanston	IL
The Cradle	Evanston	IL
Lifesong for Orphans	Gridley	IL
Adoption ARK, Inc.	Buffalo Grove	IL
ACT (Adoption in Child Time)	Indianapolis	IN
Families Thru International Adoption	Evansville	IN
MLJ Adoptions	Indianapolis	IN
Christian Family Services of the Midwest, Inc.	Portland	KS
Youthville		KS
Resources4adoption.com	Eudora	KS
Adoption Beyond, Inc.	Overland Park	KS
American Adoptions		KS
All Blessings International, Inc.	Owensboro	KY
Catholic Charities of the Diocese of Baton Rouge	Baton Rouge	LA
RainbowKids.com Adoption Advocacy	Harvey	LA
A Red Thread Adoption Services, Inc.	Norwood	MA
Wide Horizons for Children	Waltham	MA
Ascentria		MD
Adoptions Together	Silver Spring	MD
Global Adoption Services, Inc.	Bel Air	MD
Adoptive and Foster Families of Maine	Saco	ME
Bethany Christian Services	Grand Rapids	MI
Michigan Association for Foster, Adoptive, and Kinship Parents		MI
Adoption Associates, Inc.	Jenison	MI
Americans for International Aid and Adoption	Troy	MI
Family Enrichment Center	Battle Creek	MI
European Children Adoption Services	Plymouth	MN
Children's Home Society and Family Services	St. Paul	MN
My Adoption Advisor, LLC	Minnetonka	MN
National Foster Parent Association		MN
Minnesota Foster Care Association	Burnsville	MN
Evolve	Minneapolis	MN
Children's Hope International	St. Louis	MO
Lutheran Family and Children's Services of Missouri	Independent city	MO

Adoption Tax Credit Working Group:—Continued

New Beginnings International Children's and Family Services	Tupelo	MS
Christian Adoption Services, Inc.	Matthews	NC
Carolina Adoption Services, Inc.	Greensboro	NC
Children at Heart Adoption Services, Inc.	Wilmington	NC
Hopscotch Adoptions, Inc.	High Point	NC
Creating a Family	Brevard	NC
Nebraska Foster and Adoptive Parent Association	Lincoln	NE
New Hope for Children	Newmarket	NH
Golden Cradle Adoption Services	Cherry Hill	NJ
Adoption STAR	Amherst	NY
Adoptive Families magazine	New York	NY
Ashcraft, Franklin, Young, and Peters, LLP	Rochester	NY
Forever Families Through Adoption, Inc.	Rye Brook	NY
Helpusadopt.org	New York	NY
USAdopt, LLC	New York	NY
Adoptive Parents Committee Inc.	New York	NY
Michael S. Goldstein, Esq., LCSW	Rye Brook	NY
Family Focus Adoption Services	Little Neck	NY
NYSCCC	Brooklyn	NY
Spence-Chapin	New York	NY
Baker Victory Services	Lackawanna	NY
Law Office of Barbara Thornell Ginn	Cincinnati	OH
Spirit of Faith Adoptions	Sylvania	OH
Caring for Kids	Cuyahoga Falls	OH
Tuscarawas County Job and Family Services	New Philadelphia	OH
National Down Syndrome Adoption Network	Cincinnati	OH
European Adoption Consultants, Inc.	Strongsville	OH
National Center for Adoption Law and Policy	Columbus	OH
Dillon International, Inc.	Tulsa	OK
Foster Family-based Treatment Association	Norman	OK
Journeys of the Heart Adoption Services	Hillsboro	OR
All God's Children International	Portland	OR
Holt International Children's Services		OR
Oregon Post Adoption Resource Center	Portland	OR
SPOON Foundation	Portland	OR
The Sparrow Fund	Phoenixville	PA
Madision Adoption Associates	Perkasie	PA
Together as Adoptive Parents, Inc.	Harleysville	PA
La Vida International	Malvern	PA
Three Rivers Adoption Council	Pittsburgh	PA
A Chosen Child Adoption Services	Summerville	SC
Miriam's Promise	Nashville	TN
Fund Your Adoption	Gallatin	TN
ONE Church, One Child—OCOC Texas		TX
Buckner International	Dallas	TX
Gladney Center for Adoption	Fort Worth	TX
Texas Foster Family Association	Pflugerville	TX
Generations Adoptions	Waco	TX
Upbring	Austin	TX
Forever Bound Adoption	Morgan	UT
Youth Villages, Inc.	Arlington	VA
The Barker Foundation	Falls Church	VA
Friends in Adoption	Middletown Springs	VT
Amara	Seattle	WA
Agape Adoptions	Sumner	WA
Children's House International	Ferndale	WA
WACAP (World Association for Children and Parents)	Seattle	WA
Foster Parents Association of Washington State	Bremerton	WA

Adoption Tax Credit Working Group:—Continued

Faith International Adoptions	Tacoma	WA
Families Like Ours, Inc.	Seattle	WA
Lutheran Social Services of Wisconsin and Upper Michigan, Inc.	Milwaukee	WI

AMERICAN RETIREMENT ASSOCIATION (ARA)

The American Retirement Association ("ARA") thanks Chairman Hatch, Ranking Member Wyden, and the other members of the Senate Finance Committee for holding a hearing on individual tax reform and for the opportunity to submit this statement for the record.

The ARA is an organization of more than 20,000 members nationwide who provide consulting and administrative services to retirement plans that cover millions of American workers and retirees. ARA members are a diverse group of retirement plan professionals of all disciplines, including: financial advisers, consultants, administrators, actuaries, accountants, and attorneys. The ARA is the coordinating entity for its four underlying affiliate organizations, the American Society of Pension Professionals and Actuaries ("ASPPA"), the National Association of Plan Advisors ("NAPA"), the National Tax-deferred Savings Association ("NTSA") and the ASPPA College of Pension Actuaries ("ACOPA"). ARA members are diverse but united in a common dedication to America's private retirement system.

We wish to submit this statement for the record because we want to highlight our concern about the testimony of one witness—Lily Batchelder—who called for restructuring the tax incentives for retirement savings into a refundable tax credit. She also claimed that "the lion's share of tax incentives for retirement savings go to the wealthy." Unfortunately, the assertion that the tax incentives for retirement are *upside down* is a common myth that we would like to dispel. Thanks to the balance imposed by the current law contribution limits and stringent nondiscrimination rules, these tax incentives are *right side up*—even before properly considering other components of this incentive.

How is the tax benefit distributed?

The distribution of the tax benefit for saving in a defined contribution retirement plan is typically analyzed by applying the marginal tax rate to *current contributions.* This analysis reflects the progressive nature of the U.S. income tax system, because the value of the tax benefit of the deferral increases as the marginal tax rate increases.[1]

Focusing on contributions within the context of this progressive income tax structure, would lead one to expect the tax benefit for retirement savings would favor only higher income individuals. Yet, there are important characteristics of retirement savings that are omitted from this simplistic analysis.

First, current contributions to employer plans are subject to non-discrimination rules and compensation limits. These rules limit not only the deferral rates permitted by higher income participants, but also limits the amount of compensation that may be considered for purposes of determining contributions. Together, these rules place limitations on the disparities in the contribution levels.

Second, retirement incentives encourage savings while the individual is working to provide income during retirement. The focus on contributions ignores the benefits to retirees. In retirement, lower income individuals tend to continue to receive tax benefits, as their retirement savings is typically subject to tax at a lower rate compared to their working years (see chart one).[2]

Third, the analysis ignores that much, if not all, of the apparent tax savings to a small business owner accrues to employees in the form of employer contributions. Employer contributions represent a critical contribution to lower-wage participants. In many cases, complying with safe harbor rules means that the only savings many lower-wage participants receive are these employer contributions.

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[1] In any given year, the number of contributors will outnumber the retirees making distributions, further exaggerating this distribution of tax benefits.

[2] Internal Revenue Service, Statistics of Income Table 1.4, Sources of Income by Adjusted Gross Income and W–2 Tabulations.

Chart One

IRS, SOI Table 1.4, Sources of Income by Adjusted Gross Income and W-2 Tabulations

Finally, analyzing the benefit for contributions in a given year provides only a snapshot of the benefits, and fails to recognize the disparity in tax rates applied to distributions and tax treatment of other retirement benefits. For example, small business owners' distributions will face a higher marginal income tax rate than for those with a history of lower contributions. In addition, the small business owner will be required to include more Social Security benefits in income. As a result, failure to consider future tax treatment tends to overstate these relative benefits offered by the current system.

The standard methodology for measuring the benefit of the tax incentive (multiplying marginal rate by income deferred) shows tax incentives for employer-sponsored retirement savings favor higher income individuals. The analysis simply captures the inequality of income, rather than uneven tax benefits. However, because of the unique nature of this tax incentive, this methodology actually *understates* the benefits of the current retirement incentives. A more comprehensive analysis of the distribution of the tax incentives would show the current tax incentives for retirement savings are distributing benefits to low- and moderate-income workers.

Replacing the Retirement Exclusion With a Credit

Lily Batchelder's testimony also stated that "the tax incentives for retirement savings are a particularly fruitful area for reform" without getting into further specifics about how to achieve her goal. However, we believe that she is referencing a recurring proposal that would convert the current year retirement plan contribution exclusion from income into a uniform tax credit.

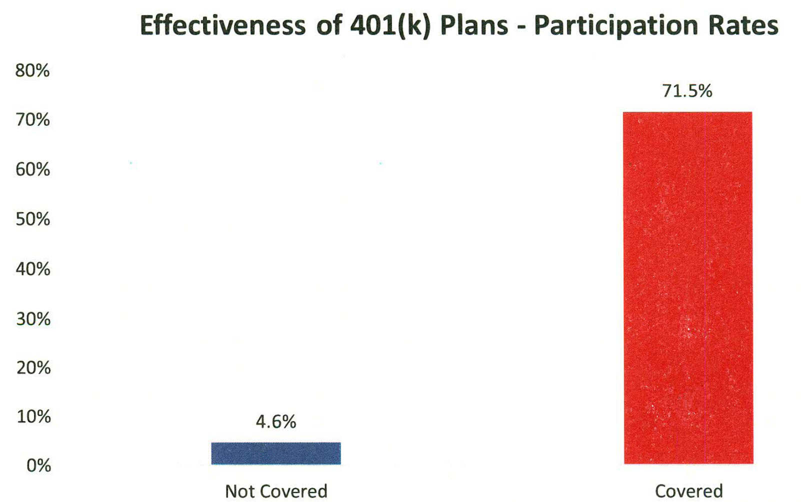
How a proposal such as this affects retirement plan sponsors and participants depends, of course, on what the level of credit is, and whether or not it is deposited to a retirement savings account or directly offsets income tax liability. A past proposal[3] from William Gale of the Tax Policy Center offers both a 30 percent, which the paper says would be revenue neutral, and an 18 percent credit. This proposal purports to create additional savings by providing more incentive for taxpayers below the 23 percent and 15 percent marginal tax brackets to save.

Data shows the primary problem to be addressed in improving retirement security is increasing *access to workplace savings,* not a lack of incentive for take-up by moderate income participants with access. More than 70 percent of workers earning $30,000 to $50,000 participate in a workplace retirement plan at work, but fewer

[3] William G. Gale, *A Proposal to Restructure Retirement Savings Incentives in a Weak Economy With Long-Term Deficits,* September 2011.

than 5 percent will save through an IRA on their own (see chart two).[4] These plans primarily benefit the middle class: 68 percent of active participants in 401(k) plans have an adjusted gross income (AGI) of less than $100,000 per year. Thirty-five percent of participants have an AGI of less than $50,000 (*see* chart three).[5] Americans earning between $25,000 and $75,000 save seven times more in retirement savings—largely through participation in workplace retirement plans—than any other type of savings.[6]

Chart Two



Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan – IRA only)

This proposal has several basic flaws. The proposal itself indicates that the current tax incentive for many decision makers would be reduced under the proposal. In fact, for the business owner, the reduction in the incentive would be *more* than illustrated in the proposal because contributions made on behalf of employees would become subject to FICA. In other words, the "problem" being addressed by this proposal is not the problem, and the "solution" will only make the situation worse.

If the credit is an offset from income tax liability, the size of the credit for a small business owner would determine if setting up or maintaining the plan is still worthwhile. If the credit were deposited to a retirement account, in many cases the resulting drain on cash would necessarily result in lower contributions for the small business owner and employees, or termination of the plan. For larger employers, the size of the credit will in no way offset additional FICA liability. They would have to take on the additional cost, or decrease contributions.

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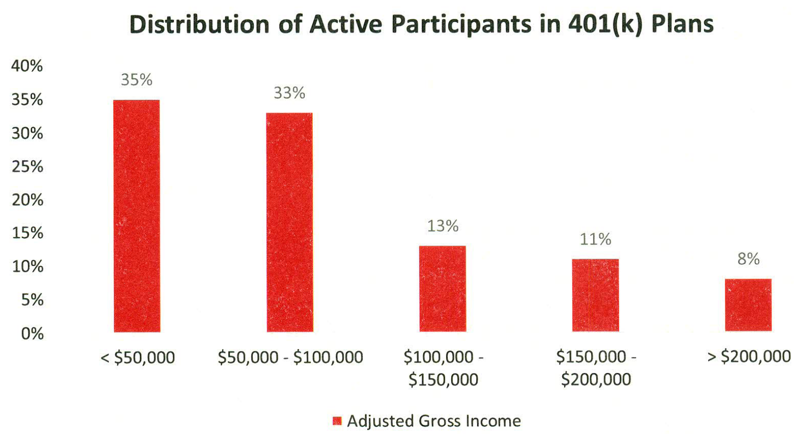
[4] Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan—IRA only).
[5] Internal Revenue Service, Statistics of Income, IRA Studies, 2014.
[6] Employee Benefit Research Institute estimate of the 2013 Survey of Consumer Finance.

Chart Three



Internal Revenue Service, Statistics of Income, IRA Studies, 2014

The paper notes that a 30 percent credit is equivalent to a 23 percent deduction. Similarly, an 18 percent credit would be equivalent to a 15 percent deduction. The equivalency is based on the theory that only the after-tax amount of income will receive the credit. For example, if an employee defers $1,000 under the current incentive system and is in the 15 percent bracket, under current rules, $150 of income tax liability is deferred. Under the proposal, the after-tax deferral would be $850. Eighteen percent of $850 is $150, so this credit is equivalent to the exclusion for income tax purposes. This analysis makes sense in the case of IRA contributions or elective deferrals, where FICA is already paid on the contribution amounts. It does not hold up, however, for employer contributions, where there is currently no FICA liability for either employees or employers.

Consider an employee in the 15 percent bracket contributing $1,000 as an elective deferral and receiving a $1,000 employer contribution. *If the level of employer contribution does not change,* the employee will not only offset the $1,000 elective deferral by the $150 income tax liability on the elective deferral, but also by the $150 income tax liability for the employer contribution and the $76 in FICA contributions the employee owes on this employer contribution amount. Instead of $2,000 in total contributions, there will be $1,624 ($2000 – $150 – $150 – $76). An 18 percent credit applied to $1,624 is only $292. So the employee has lost over $80 in this change to an "equivalent" 18 percent credit. For this situation, the equivalent credit would be about 23 percent. Note, however, that the higher the level of the employer contribution relative to the elective deferral, the higher the credit must be for the individual to break even. If there were a $2,000 employer contribution, an 18 percent credit would result in a reduction of over $171, after FICA is considered, and the equivalent credit would be over 25 percent.

Considering the FICA implications, this proposal has the effect of penalizing both business owners (through increased FICA taxes) and employees when the plan provides for matching or profit-sharing contributions, with the penalty increasing as the employer contribution increases. Regardless of the size of the credit, this is an incentive for all employers, not just small business owners, to reduce company contributions.

Conclusion

The current retirement savings tax incentives work well to promote good savings behavior for tens of millions of working Americans. If anything, these incentives—for both employers and employees—should be enhanced. At a minimum, any modifications to the current incentives should be evaluated based on whether or not the changes will encourage more businesses to sponsor retirement plans for their employees. Restructuring the tax incentives for retirement savings into a uniform tax credit would fail this evaluation and should be rejected.

CALIFORNIA ASSOCIATION OF REALTORS (CAR)
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Los Angeles, CA 90020
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https://www.car.org/

September 20, 2017

The Honorable Orrin Hatch and The Honorable Ron Wyden
U.S. Senate
Committee on Finance
215 Dirksen Senate Office Building
Washington, DC 20510

Re: "Individual Tax Reform" Hearing; Testimony of the California Association of Realtors

Dear Chairman Hatch and Ranking Member Wyden,

On behalf of the more than 190,000 members of the California Association of Realtors (CAR), I am submitting the following statement for the committee's hearing entitled "Individual Tax Reform," that will examine ways to improve the U.S. tax system for America's families and individuals. I would like to thank you for taking the time to hold this important hearing on tax reform, an issue that will impact all Americans. As CAR and its members look at the issue of tax reform, two important issues stand out; (1) Congress must maintain an incentive for renters to become homeowners, and (2) Congress must not raise taxes on homeowners.

Unlike other pieces of legislation that may impact a specific industry or a select socio-economic class, tax reform will impact EVERY industry and ALL Americans. For this reason, Congress must avoid rushing tax reform through backroom deals. An issue of this magnitude needs to move through the full congressional process. This includes transparency through committee hearings, amendments, markups, full floor debates, and votes. The American taxpayers deserve nothing less.

CONGRESS SHOULD INCENTIVIZE HOME OWNERSHIP

For over 100 years Congress has incentivized home ownership with the tax code; currently through the mortgage interest deduction. Any effort at reforming the tax code should maintain and prioritize this incentive. Unfortunately, many of the proposals for tax reform include the doubling of the standard deduction, would for practical purposes eliminate the incentive effect of the mortgage interest deduction. Under the proposals, it is estimated only 5-percent of taxpayers will itemize their deductions, therefore the vast majority of people will no longer receive any tax incentive to purchase a home. So, while Congress may state the proposals are keeping the mortgage interest deduction, the incentive effect of the deduction for Americans to become homeowners and thereby stakeholders in their community would disappear.

Severely reducing the incentive to home ownership will lower home ownership rates in the U.S. This will financially hurt households and shrink the middle class. If Congress maintains or increases the incentive for home ownership, Congress will be taking the necessary steps to financially strengthen America's households and grow the middle class. According to the Federal Reserve, over the last 28 years the median net worth of households that own homes has averaged $193,000. This is in comparison to $5,300 for households that rent over the same time. This is because home ownership allows individuals and families to build wealth through principal reduction, equity appreciation, stable monthly payments, and create generational wealth. It also allows seniors who pay off their mortgage or have a stable mortgage payment to live securely and with stability in their residences and community without fear of being displaced due to rent increases.

CONGRESS SHOULD NOT INCREASE TAXES ON HOMEOWNERS

Congress needs to protect taxpayers from double-taxation and maintain the deduction for state and local taxes including property taxes. Not allowing the average homeowner in California to deduct their property, state and local taxes would effectively be raising their taxes more than $2,400 a year! The Federal Government would tax families on money paid to the state and local governments they never used. Effectively this is akin to double taxation of the homeowners and taxpayers of states with state and local taxes.

Additionally, eliminating the ability to deduct state and local taxes would further punish Californian families who already pay more to the Federal Government than they receive. According to the 2014 IRS data book California paid $369 billion dollars to the Federal Government, of which according to the Pew Charitable Trusts, only $356 billion was sent back to Californians. Eliminating the ability to deduct property, state and local taxes will further increase this discrepancy and harm California homeowners.

PROTECT CAPITAL GAINS EXCLUSION FOR PRIMARY RESIDENCES

Congress must keep and improve the capital gains exemption for the sale of a primary residence. Under current law, the first $250,000 in capital gains for single-tax filers or $500,000 in capital gains for joint-tax filers on the sale of their primary residence is not taxed. This has allowed for millions of households to build equity in their homes and supplement their social security when they retire. However, protecting this vital tax provision is not enough, and Congress should take additional steps to help these homeowners even more.

Congress should eliminate the "single tax filer" and have only the higher exemption of $500,000 apply to all primary residences regardless of the marital status of the owner. By having the higher amount for all primary residences, Congress will ensure widowers and divorced individuals are not punished. Additionally, this tax provision should be indexed for inflation. For 20 years the benefit of this tax provision has eroded because the amount has sat stagnant. If the exclusion is indexed for inflation, Congress should use 1997 (the year the law was enacted) as the base year.

DON'T PAY FOR LOWER CORPORATE RATES ON THE BACK OF HOMEOWNERS

As independent contractors, almost every Realtor is their own small business, so CAR understands the importance and benefit of a lower corporate tax rate. However, Congress cannot and must not pay for lower corporate tax rates by effectively increasing the taxes of homeowners by eliminating or reducing their deductions. Any reduction to the corporate tax rate must be offset by corporations.

CAR looks forward to working with the Senate as it works to reform the tax code. We would be happy to discuss any of these issues further with you and your staff; you may contact Matt Roberts, Federal Government Affairs Manager at 213–739–8284 or matthewr@car.org. Thank you for taking into consideration our comments.

Sincerely,
Geoff McIntosh
2017 President, California Association of Realtors

CHARITABLE GIVING COALITION (CGC)

U.S. Senate
Committee on Finance
Dirksen Senate Office Bldg.
Washington, DC 20510–6200

Chairman Hatch, Ranking Member Wyden, and Members of the Senate Committee on Finance:

The Charitable Giving Coalition (CGC) welcomes the opportunity to submit comments to the official record for the recent Committee Hearing on Individual Tax Reform.

As noted in the hearing announcement, Mr. Chairman, your goal was to "examine ways to streamline the individual tax system to make it work better for American individuals and families." With this focus on individuals and families, the CGC wants to make certain that you and your colleagues consider the direct connection between changes to the individual tax code and the well-being of America's charities.

The CGC heeded your call in July to submit comments on Tax Reform, which we incorporate here by reference. In this submission, we aim to update those comments.

The CGC is submitting our remarks to you today with an added sense of urgency. In yesterday's release of the *Unified Framework for Fixing Our Broken Tax Code,* we note that the outline, albeit brief, does not address the consequence of the significant re-configuration of the individual income tax code to charitable giving, the organizations it supports and the people served. While the White House draws a connection between a strong civil society and vibrant charitable giving, and leaders in Congress have expressed interest in unlocking more donor dollars for charities across the country, the *Framework* seems to fall short for America's charities.

For that reason, we implore you to consider the impact of new tax policy on vulnerable communities as you convert this *Framework* to detailed legislation. Based on the *Framework's* general outline, the Charitable Giving Coalition (CGC) believes the plan would generate dramatic, negative consequences for charities and the constituents they serve because the charitable deduction will be available to only 5% of all taxpayers—causing a significant drop in contributions. The other 95% of taxpayers will be taxed on their gifts to charity.

Tax reform that strengthens American communities, spurs economic growth and supports America's hard-working families, especially those in middle- and lower-income brackets, must incentivize charitable giving. The *Framework* acknowledges that certain "tax benefits help accomplish important goals that strengthen civil society, as opposed to dependence on government: home ownership and charitable giving."

However, under the *Framework,* the scope and value of the current charitable deduction would vastly diminish. If the standard deduction nearly doubles, the percentage of taxpayers who itemize will drop from approximately 33.3% to only 5%, effectively meaning only 5% of all taxpayers can take the charitable deduction. In real terms, 30 million taxpayers who itemized in 2016 will no longer have the giving incentive and will be taxed on their gifts. The result would be a staggering loss of *up to $13 billion in contributions annually,** undermining America's charitable organizations and our country's extraordinary tradition of philanthropy.

Americans are, undeniably, generous. This has been strikingly evident in the wake of the unprecedented natural disasters that we've experienced in recent weeks. The public response reinforces the American tradition of giving. Consider just one example: The "Hand in Hand Benefit for Hurricane Relief" telethon on Tuesday, September 12th, raised over $44 million in one evening. "Hand in Hand" is one of thousands of fundraising efforts, small and large, collecting donations and distributing them to a broad cross-section of relief providers in the areas ravaged by recent hurricanes. From individual gifts and small giving circles to the "One America Appeal" being led by all five former living Presidents of the United States, the best of our American ethos to collectively support our communities is—as always—in action.

Congress must assure that we retain charitable giving, and unlock more, as it navigates the complexities of tax reform.

As you know from our comments submitted in July and subsequent outreach to Committee Members, the CGC has proposed a fair and efficient resolution that will continue to encourage Americans to redirect their dollars to charities: a universal charitable deduction available to all taxpayers. This will assure that contributions to charities are not taxed by the federal government and that taxpayers who currently take the deduction for their gifts will continue to be incentivized. Furthermore, because the deduction will be available to all taxpayers, it could foster a culture of giving much earlier, providing an incentive to young taxpayers who are beginning to make their charitable investments in the communities and causes they care about.

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*According to a study commissioned by Independent Sector and conducted by Indiana University Lilly Family School of Philanthropy, "Tax Policy and Charitable Giving, Results," May 2017, Indiana University Lilly Family School of Philanthropy Study commissioned by Independent Sector, *https://www.independentsector.org/wp-content/uploads/2017/05/tax-policy-charitable-givinq-finalmay2017-1.pdf.*

With the latest U.S. Census figures showing that middle-class households are only now seeing their income reach 1999 levels—and with economists concerned that recent gains may not continue—a universal charitable deduction is easy for taxpayers to use and will provide tax relief for families across America who give to charity but don't itemize their taxes.

More than a dozen United States Senators, including members of the Senate Finance Committee, recognized that tax reform must not diminish charitable giving when they sponsored The CHARITY Act of 2017 (S. 1343.) That bill expressly states that: (1) encouraging charitable giving should be a goal of tax reform; and (2) Congress should ensure that the value and scope of the deduction for charitable contributions is not diminished during a comprehensive reform of the tax code

As the Committee advances it efforts to enact tax legislation that is good and fair for all Americans, the CGC will continue to advance the universal deduction as a solution to the expected loss in giving from the current tax *Framework*. Our collective, unifying goal should be to ensure that America's communities thrive and her charities remain strong, diverse and effective.

Thank you for this opportunity to submit comments to the hearing record. We look forward to our continued efforts to educate the Committee and advance our legislative proposal for a universal charitable deduction.

Coalition to Preserve Cash Accounting

September 27, 2017

The Honorable Orrin Hatch	The Honorable Ron Wyden
Chairman	Ranking Member
U.S. Senate	U.S. Senate
Committee on Finance	Committee on Finance
219 Dirksen Senate Office Building	219 Dirksen Senate Office Building
Washington, DC 20510–6200	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 September 14, 2017 hearing on "Individual Tax Reform." 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 partnerships, 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
American Society of Interior Designers
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 (U.S.) LLP
Steptoe and Johnson LLP
White and Case LLP

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September 14, 2017

Chairman Orrin Hatch and Ranking Member Ron Wyden
Senate Finance Committee
219 Dirksen Senate Office Building

[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 letter to the Senate Committee on Finance sent in April 2017 is available at *http://bit.ly/2xvv6YB*.

The Jewish Federations of North America ("JFNA") is the national organization that represents 148 Jewish Federations, their affiliated Jewish community foundations, and more than 300 independent network communities. In their individual communities, the Jewish Federation and network volunteers (collectively the "Federation system") is the umbrella fundraising organization as well as the central planning and coordinating body for an extensive network of Jewish health, education, and social service agencies. Thus, the Federation system raises and allocates funds for almost 1,000 affiliated agencies that provide needed social, medical and educational services to almost one million individuals throughout the country, including Jews and non-Jews alike.

We applaud the Senate Finance Committee for holding a hearing on September 14, 2017 on Individual Tax Reform as part of the committee's continued work to enact comprehensive tax reform and submit the following statement to the hearing record.

Background: Each Jewish Federation conducts a yearly fundraising endeavor ("the annual campaign") and collectively the Federation System raises almost $950 million each year from over 400,000 donors. In addition, the planned giving and endowment departments of Federations and their affiliated Jewish community foundations raise almost $2 billion each year through a variety of planned giving vehicles including charitable gift annuities, charitable trusts, donor advised funds, and supporting organizations, among others. Grants from such planned gifts also flow to support annual mission-related charitable activities. The combination of a large annual campaign and sophisticated planned giving operations serve to make the Federation system one of the largest philanthropic networks in North America. As such, we are vitally concerned regarding the impact that fundamental tax reform could have on charitable giving incentives and giving vehicles.

The Federation system is especially proud of the important role that certain endowed vehicles such as donor-advised funds and supporting organizations play in maintaining active grant-making programs in support of our mission as well as building long-term endowment assets that assure the continued existence of the our philanthropic and social service organizations. According to our most recent financial survey, Jewish Federations and affiliated Jewish community foundations have combined endowment assets of approximately $20 billion and make annual grants that exceed $2 billion from such funds to other public charities, with significant charitable distributions flowing to support both Jewish and non-Jewish causes, domestically and internationally.

During the past month, as various parts of the United States, including territories in the Caribbean have been devastated by an unprecedented number of natural disasters, we are also reminded of the important role that private philanthropy plays in provided needed assistance to impacted families as well as working to rebuild community infrastructure. We are proud of the fact that collectively the federation system has raised over $15 million to aid communities in Texas, Florida, and the Islands with additional funds expected to be collected over the next weeks and months. We would urge the committee to consider passing a package of tax incentives to further encourage such giving, including a suspension of the current adjusted gross income limitation on annual deductible charitable contributions.

Our Charitable Mission and the Tax Code: Perhaps the primary mission of the Federation system is to inspire its donors as members of the Jewish community to fulfill our religious duty to be charitable ("tzedakah") and to meet our collective responsibility to build community and improve the entire world ("tikkun olam"). Although it is true that the importance of these principles transcend the Internal Revenue Code of 1986 (hereinafter "the Tax Code") or particular statutory incentives such as the charitable contribution deduction, we have come to recognize that such provisions permit many of our donors to extend their levels of generosity. It is these charitable contributions that truly are the lifeblood of the Federation system allowing it to meet our operational mandates, achieving a variety of philanthropic goals.

Fundamental Tax Reform and the Importance of Giving Incentives: We applaud the Senate Finance Committee and the Administration for tackling the complexity surrounding fundamental tax reform and we support efforts to make the tax code simpler, more efficient, and more competitive in today's global economy. We are also appreciative of the virtually unanimous support that charitable giving incentives continue to receive from policy-makers.

The federal income tax has included tax incentives to promote charitable donations for over 100 years. Although it has undergone numerous revisions and amendments, often tightened by adding regulatory rules and requirements for certain types of donations or restrictions to the operations of certain giving vehicles, and sometimes broadened by raising the contribution limits or expanding the types of permissible charitable donees, the concept of a deduction for contributions to charitable organizations remains fundamental to the social contract that binds individuals, charities, and the government to support the most vulnerable among us.

Similar to other large national charities, the Federation system has a sophisticated fund-raising operation as well as highly-organized procedures for allocating funds to a broad range of social service programs and general charitable needs throughout their communities and overseas. As such, we see both sides of the charitable deduction equation: how donors react to tax provisions, as well as the role that philanthropic dollars play to support programs assisting the most vulnerable. Our perspective on the income tax code and charitable giving incentives is grounded in over 100 years of such real-world experience.

Although the donor base to our annual campaign is large, we also recognize that the vast amount collected comes from a relatively small number of gifts. As a result, a so-called "90–10" rule operates so that the overwhelming percentage of dollars raised flow from a small, but tax-sophisticated donor group, who regularly make large gifts, either through the annual campaign contribution or more importantly, through the use of planned giving vehicles, as discussed below. This tax sophistication permits such individuals and their planned giving advisers to structure gifts so that the maximum amount of funds flows to Jewish Federations and, in turn to beneficiary agencies, today, rather than later. This perspective convinces us that each of the several "proposals" to reform the charitable contribution deduction, such as a limitation in the value of the deduction, an overall cap on itemized deductions, or even a "floor" on deductible contributions, as contained in the 2014 Tax Reform draft proposed by former House Ways and Means Committee Chairman Dave Camp (R–MI) ("Camp Draft") will lead to a significant decrease in giving to the JFNA System. As government funding for social service and medical programs continues to decrease, any such diminution in support of charitable contributions will further hamstring the operations of Jewish Federations and their affiliated agencies in their mission to help the most vulnerable among us.

We are also concerned that the interaction of several provisions under discussion in a variety of "fundamental tax reform" plans could combine to have a detrimental impact on charitable giving. A substantial increase in the standard deduction, combined with the elimination or limitation on a number of other "itemized deductions" will have the effect of greatly reducing the number of taxpayers who will claim itemized deductions, effectively removing the charitable contribution tax incentive for such taxpayers. It is beyond dispute that a dramatic decrease in the number of taxpayers who claim the charitable contribution deduction, combined with a decrease in individual income tax rates will have a profound negative impact on dollars given to charity. Indeed, a recent study conducted by the Indiana University School of Philanthropy confirms that the contemplated changes discussed above would result in a decrease in annual giving of over $13 billion. As such, we understand that many organizations within the charitable sector are endorsing a proposal to expand and enhance charitable giving incentives by providing a "universal deduction" to taxpayers who do not itemize. Proponents argue that a universal (or "above-the-line") deduction would increase giving, in terms of both dollars and donors, increase fairness by incentivizing all taxpayer's contributions, and provide modest tax relief to middle- and lower-income taxpayers. In addition, the dollars flowing to America's charities would increase. This result is bolstered by the results of the Indiana University study that indicates that the inclusion of an above-the-line deduction in the Tax Code would result in a full recoupment of potentially lost contributions plus an additional $5 billion each year. We recognize that some tax policy experts have raised concerns that an above-the-line deduction could cause compliance and enforcement issues. We would look forward to working with you and the Finance Committee on a proposal that would have the effect of increasing charitable giving incentives as well as address the tax policy issues noted above.

Importance of Other Charitable Vehicles: Over the past several decades, the Federation system has fostered growth in charitable giving through donor advised funds and supporting organizations (known as "participatory funds"). Participatory funds, whose existence stems from the charitable contribution deduction, offer an economical and efficient means for those with sufficient assets and charitable intent to benefit the community through an ongoing relationship with public charities such as Federations or affiliated Jewish community foundations. Such funds are an indispensable tool in encouraging intergenerational involvement in charitable activities through family philanthropy. In addition to providing financial resources for critical human services in the local Jewish and general communities, and supporting charitable causes across the globe, participatory funds also advance the values and goals of the Federation system through nurturing relationships between philanthropists and Federation volunteer and professional leadership, as well as helping to build endowment assets.

In recent years, participatory funds also provide a reliable pool of dollars to support the annual campaigns of Jewish Federations, which is the primary financial resource for ongoing operating budgets. Grants from these funds now comprise up to 20 percent of the annual campaign. Additional grants to Federations are common in the case of extraordinary needs or supplemental campaign for natural and man-made disasters, as well as during economic downturns such as the one experienced just a few years ago.

Permitting, indeed encouraging, participatory funds to exist for extended periods of time provide Federations and related Jewish community foundations the ability to grow the assets of these publicly supported charities. Healthy endowments at Federations and related Jewish community foundations help to assure the continued existence of these organizations for generations to come. This is why any proposal that would effectively require donor advised fund contributions to be distributed within a limited period of years, such as one that was contained in the 2014 Camp Draft, would undermine the broader charitable purpose of such funds and could be devastating to participatory funds in general and Jewish Federations in particular. Our donors, especially those who support our work by establishing participatory funds with us, ensure that we continue to fulfill our charitable mission through grants to worthwhile charitable endeavors. Rather than adhering to an arbitrary numerical formula, our philanthropic spending policy is truly donor-driven and recognizes community needs both today and into the future.

As the Committee continues to consider tax reform proposals, we urge that participatory funds be allowed to flourish and be left with a minimum of regulatory burdens. JFNA agrees with the bottom-line conclusion of the Treasury Department's *Report on Supporting Organizations and Donor Advised Funds* issued in December 2011, that "the Pension Protection Act of 2006 appears to have provided a legal structure to address abusive practices and accommodate innovations in the sector without creating undue additional burdens or new opportunities for abuse." The Treasury Report further notes that "it is appropriate that the contribution deduction rules applicable to donors to supporting organizations and donor advised fund sponsoring organizations are the same as those applicable to donors to other public charities."

Conclusion: The Federation system applauds the Senate Finance Committee for undertaking such a deliberative process and analyzing the many issues that need to be considered in contemplating fundamental tax reform. As it pertains to the charitable contribution deduction and charitable giving, however, we remind the Committee that any proposal that could result in a decrease in charitable giving will have significant negative consequences for America's charities, including the Federation system, and most importantly, the vulnerable populations that we serve. The charitable contribution deduction remains the only provision in the income tax law where an individual must "give away" income or assets in order to receive a deduction. As has been true since the enactment of the income tax law, this selfless act deserves to be promoted and encouraged by the tax code.

We are proud that Federations and affiliated Jewish community foundations employ the highest ethical standards of self-regulation in the governance and operation of our fundraising and planned giving practices and regularly share our expertise with policy makers and charities outside of the Jewish community on a variety of charitable giving issues. We continue to work closely with officials at the Treasury Department and the Internal Revenue Service as they work to promulgate guidance on some of the provisions added to the tax code by the Pension Protection Act of 2006 ("PPA") regarding donor advised funds and supporting organizations.

The Federation system remains committed to ensuring that federal tax policies, especially the charitable deduction, continue to incentivize the flow of funds from individuals to public charities. We realize that the Committee will face difficult decisions over the next several months. We urge you, however, to continue to support policies that will strengthen our national heritage of broad-based philanthropy.

We would be more than happy to amplify our comments or answer any questions. Please feel free to contact either william.daroff@jewishfederations.org (202–736–

5868) or Steven Woolf, JFNA senior tax policy counsel at steven.woolf@jewishfederations.org or (202–736–5863).

LETTER SUBMITTED BY WILLIAM S. KIRK

September 21, 2017

Senate Committee on Finance: Attention Orrin Hatch, Chairman

Dear Senator Hatch;

Since tax reform is on the agenda, I am writing to ask you to consider how Social Security and Medicare are intertwined with tax reform and benefits.

(1) Social taxation thresholds have not been changed since 1984. They are currently $32,000 for a married couple. They were never indexed for inflation; and in today's dollars this threshold should be around $75,000. I ask that you consider bring these frozen figures into the 21st century to catch up to other government programs adjusted for inflation.

(2) Medicare monthly premiums have risen from $104.90 in 2015 to $121.80 in 2016 (16.1%) to $134 in 2017 (10.0%). How can this be justified when Social Security benefit increases in 2015 were 1.7%; 2016 were 0%; 2017 were 0.3%. These minuscule Social Security increases are eaten up by Medicare premium increases resulting in frozen Social Security benefits for several years. In my case it will take 5 years of Social Security benefit increases just to cover the $134 before I see a dime increase in benefits. This math does not make sense. You can only approve a 0.3% increase for Social Security and on the other hand say double digit Medicare increases are justified. How do you rationalize these two different points of view?

I look forward to your reply and hope that you will pass legislation that will correct these two situations and bring them in line with realistic benefits that coincide with today's cost of living for recipients of these programs.

Best Regards,
William S. Kirk

LEAGUE OF AMERICAN ORCHESTRAS

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Thank you for the opportunity to provide comments for the record related to the Senate Finance Committee's hearing on individual tax reform, held on September 14, 2017. We are also grateful for this important opportunity to provide an initial response to the September 27th release of the *Unified Framework for Fixing the Broken Tax Code,* which Chairman Hatch has described as "a critical roadmap for the tax-writing committees."

The League of American Orchestras leads and supports America's orchestras and the vitality of the music they perform. Founded in 1942 and chartered by Congress in 1962, the League links a national network of thousands of instrumentalists, conductors, managers, board members, volunteers, and business partners. Its diverse membership of approximately 800 nonprofit orchestras across North America ranges from world-renowned symphonies to community groups, from summer festivals to student and youth ensembles. Orchestras unite people through creativity and artistry, fuel local economies and civic vitality, and educate young people and adults—all with the support of private contributions, volunteers, and community partners.

As the Congress prepares to take next steps in detailing a tax reform plan, we provide comments here that reiterate key points communicated to the Finance Committee by the League of American Orchestras in response to Chairman Hatch's June 16, 2017 request for stakeholder feedback on tax reform. The League of American Orchestras continues to urge the Committee to support the vital work of nonprofit organizations by preserving and strengthening tax incentives for charitable giving and supporting policies that strengthen the nonprofit sector. Private contributions are a critical source of support that enables orchestras to broaden public access to the arts, nurture cultural diversity, and spur the creation of new artistic works, all while supporting countless jobs in communities nationwide. We urge the Committee to take the following into consideration in shaping tax reform proposals:

Ensure that comprehensive tax reform results in increased giving by more donors. While leadership on House and Senate Committees has expressed support for preserving the charitable deduction and enacting policies that incentivize even more giving, the proposal in the *Unified Framework for Fixing the Broken Tax Code* to increase the standard deduction would reduce the number of itemizers that make use of the charitable deduction to just 5% of taxpayers, resulting in a loss of up to $13 billion in contributions annually. Efforts to simplify the tax process could ensure increased charitable giving by enacting a charitable deduction available to *all* taxpayers, whether or not they itemize. The League of American Orchestras endorses the statement submitted to the Committee by the Charitable Giving Coalition, which explains in detail how a universal charitable deduction would increase charitable giving by $4.8 billion per year, while cultivating new generations of philanthropists and encouraging a tradition of giving among all taxpayers.

While the initial impulse to give comes from the heart, studies have repeatedly shown that charitable giving incentives have a significant impact on how much and when donors contribute. Should charitable giving incentives be scaled back, the public would suffer. Orchestras, like other nonprofit organizations, rely on contributions from donors from across the economic spectrum. If individual donations were to decline, the capacity of nonprofit performing arts organizations to provide educational programs and widely accessible artistic events, and to boost the civic health of communities and the artistic vitality of our country, would be diminished at a time when the services of all nonprofits are most in demand. The tax incentive for charitable contributions uniquely encourages private, individual investment in the public good.

Charitable giving is an essential form of support. Declines in giving would result in the loss of vital local nonprofit programs. Orchestras, as tax-exempt organizations, are partners in the nation's nonprofit charitable sector working to improve the quality of life in communities nationwide. Orchestral activity is supported by an important combination of public volunteerism, private philanthropy, and civic support that is made possible by tax exempt status and incentives for charitable contributions. Ticket sales and admission fees alone do not come close to subsidizing the artistic presentations, educational offerings, and community-based programming of nonprofit arts organizations. In fact, orchestras participating in the League's Orchestra Statistical Report in 2014 indicated that total private contributions represent 39.7% of the revenue that makes the work of U.S. orchestras possible.

Reducing incentives for charitable giving would harm communities. Nonprofit jobs account for 1 in 10 members of the U.S. workforce. American orchestras employ thousands of professional musicians, administrators, educators, and stage personnel in cities and towns across the country. These workers are key contributors to their local creative economy through their day-to-day work, boosting their community's reputation for excellence and competitive edge. They are also planting the seeds for future economic growth through the educational, artistic, and civic programs they present to young people, nurturing the next generation of workers who will be prepared to contribute to the global economy—which is increasingly reliant on creativity and the communication of ideas. The jobs and work product of many artists and administrators working in the nation's nonprofit performing arts community would be imperiled by declines in charitable giving.

Maintain and strengthen the IRA Charitable Rollover Provision. Congress wisely recognized the importance of giving incentives by reinstating and making permanent the IRA Charitable Rollover provision in December of 2015 through the Protecting Americans from Tax Hikes (PATH) Act, after years of expiration and temporary reinstatement. The IRA Rollover provision can be strengthened by lowering the age requirement to 59½ and removing the $100,000 cap on qualifying donations.

We urge the Committee to consider carefully the impact of changes to Unrelated Business Income Tax (UBIT) requirements. Along with others in the nonprofit community, orchestras viewed with great concern the treatment of sponsorship payments in Section 5008 of H.R. 1 in the 113th Congress. Under the House bill, if a sponsorship payment exceeds $25,000 for a single event, any use or acknowledgement of the sponsor's name or logo may only appear with, and in substantially the same manner as, the names of a significant portion of the other donors to the event. Contributions acknowledged in a different manner would be treated as advertising income by the tax-exempt organization and subject to UBIT.

Current law already provides that UBIT is incurred any time the sponsor's product is advertised. Sponsorship recipients may not provide qualitative information about the product, urge its purchase, or provide any information on how or where to purchase it. The mere acknowledgement of the size of a sponsorship is no different from acknowledging the size of charitable gifts from individuals, which is standard practice for charities of every kind. Subjecting the sponsorship to tax would simply divert money from its intended philanthropic use and leave nonprofit cultural organizations with fewer resources to serve their communities.

Enact the Artist-Museum Partnership Act, S. 1174, which would allow artists, writers, and composers to take an income tax deduction for the fair market value of their work when donating it to charitable collecting institutions. For many years, artists, writers, and composers could take a fair market value deduction for their works donated to a museum, library, or archive. Currently, creators may take a deduction only for the cost of materials, such as paper and ink and, as a result, the number of works donated by artists has dramatically declined. Musicians, scholars, and the public rely on original manuscripts and supporting material to reveal the artistic underpinnings of existing compositions and inspire the creative works of emerging artists. When collected by orchestra archives, music schools, music libraries, or other cultural institutions, original musical works and related materials can be preserved and made available to the public. By allowing artists to take a fair-market value deduction for self-created works given to a nonprofit institution, their works are accessible to the public.

Orchestras are important contributors to American civic life, and nonprofit status and charitable giving to orchestras substantially improves the health, education, and artistic vitality of communities nationwide. The United States relies upon the nonprofit community to provide many public services in fields ranging from public health and education to arts and culture. The various types of charitable organizations that comprise the nonprofit sector do not exist or operate in silos. They are tightly connected through critical local partnerships that leverage shared resources and strengthen services to the public. The programs and music of America's orchestras are embraced, supported, and accessed by the public in communities large and small throughout our country. Here are facts about the contributions orchestras make to the public good:

- More than 28,000 performances are given annually by orchestras, many of them specifically dedicated to education or community engagement, for a wide range of young and adult audiences. With the support of private contributions, many of these concerts are made available free of charge, or at reduced prices that provide access to families and attendees from across the economic spectrum.
- Orchestras partner with other community-based nonprofits every day to serve specific community needs. In a national survey, our members identified more than 40 types of programmatic activities that engage community partners, including health and wellness programs, engagement of military families, senior programs, and an extensive array of music education partnerships with schools and in afterschool settings.
- Orchestral activity is embedded in the civic life of towns and cities across our country. With nearly 1,600 symphony, chamber, collegiate, and youth orchestras across the country, America is brimming with extraordinary musicians, live concerts, and orchestras as unique as the communities they serve. Thousands of young people embrace the opportunity to perform side-by-side with their peers, and adult professional and community orchestras of all sizes present extraordinary music for their communities.
- Through the power of music, orchestras unite individuals in the unique shared event of a large ensemble performance, and are often a focal point when a community seeks to commemorate an important civic moment. Orchestras are a source of strength and pride, as well as a vehicle for community unification and reflection.
- Orchestras contribute to our nation's artistic vitality, supporting the creative endeavors of thousands of today's classical musicians, composers, and conductors, while strengthening, documenting, and contributing to our nation's diverse cultural identity.

America's orchestras promote access to the arts, are important participants in education for children and adults, and support jobs and economic growth—all in partnership with other community-based organizations. On behalf of the full range of American orchestras, we urge the Committee to preserve and grow tax incentives for charitable giving and enact policies that strengthen the impact of the nonprofit sector.

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Tax Reform Proposals

Individual Tax Simplification

Alternative Minimum Tax

Internal Revenue Code: Sections 55, 56, 57, 58, 59.

The Problem: Congress created the Alternative Minimum Tax (AMT) to ensure that wealthy individuals taking advantage of tax shelters pay a minimum amount of taxes. In reality, due to tax law changes over the years, the AMT often affects taxpayers who were not the target of the original proposal: middle-class taxpayers making as little as $75,000.[1] Additionally, taxpayers from high tax states and with large families are most vulnerable to the AMT. While not common, it is even possible to find examples of taxpayers in the $50,000—$60,000 income range affected by AMT.

Recommendation: The AMT should be repealed or substantially modified to apply only to high income taxpayers paying little or no taxes.

Analysis: The AMT is a parallel tax system, requiring taxpayers to, in effect, do their taxes twice. In conjunction with the elimination of many tax avoidance provisions of the Internal Revenue Code, the AMT can be eliminated or substantially modified to target only high income taxpayers.

Personal Exemption Phase-out (PEP) and Limitation of Itemized Deductions (Pease)

Internal Revenue Code: Sections 151 and 68.

The Problem: While the Personal Exemption Phase-out (PEP) and Pease are presented as phase-outs for exemptions and itemized deductions, in reality they are hidden additional tax rates. Additionally, these phaseouts unfairly tax large families and people from high tax states.

Recommendation: Congress should repeal PEP and Pease and replace with an applicable tax rate on high-income taxpayers.

Analysis: Removing phaseouts that act as hidden marginal rates will bring better transparency and efficiency to the Internal Revenue Code. Additionally, repealing PEP and Pease will remove the large family penalty and will provide tax relief to people living in high tax states.

Child Tax Credit

Internal Revenue Code: Section 24.

The Problem: A taxpayer may claim a tax credit for each qualifying child under the age of 17. In most families, teenagers do not graduate from high school until age 18 or even 19. These years can be expensive as the child prepares to enter college or the workforce.

Recommendation: The age limit for each child should be increased from under the age of 17 to under the age of 19.

Analysis: Increasing the child age limit will help families transition children from high school to work or college.

Unearned Income of a Child, "Kiddie Tax"

Internal Revenue Code: Section 1(g).

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[1] "Characteristics of Alternative Minimum Tax (AMT) Payers, 2016–2018 and 2027," Tax Policy Center, *http://www.taxpolicycenter.org/model-estimates/baseline-alternative-minimum-tax-amt-tables-april-2017/t17-0149-characteristics.*

The Problem: The additional tax revenue to the Treasury does not outweigh the extreme complexity added to a family's tax compliance.

Recommendation: Congress should substantially increase the current threshold for unearned income subject to the Kiddie Tax from $2,100 to $6,000 (subject to annual indexing) while lowering the maximum age subject to the tax to 14.

Analysis: The intent of current law is to discourage transfers of wealth, purely for tax avoidance purposes. Changing the current threshold to $6,000 would better reflect the original threshold adjusted for inflation.

Mileage Rates

Internal Revenue Code: Sections 162, 213, 217, and 170(i).

The Problem: The IRS determines annually the allowable mileage rate as an ordinary and necessary business expense, which is currently 53.5 cents per mile. The IRS also sets a standard rate for the medical and moving deduction, which is currently 17 cents. Since 1984, the mileage rate for the charitable deduction is set by statute at 14 cents per mile.

Recommendation: The standard mileage rate deduction should be consistent for all uses.

Analysis: The proposal would treat similarly situated taxpayers equally. When charitable or medical transportation is necessary, reasonable rates should be allowed and adjusted annually.

Education

Internal Revenue Code: Sections 25A, 221, 222, 529, and 530.

The Problem: The Internal Revenue code includes such a myriad of complex tax incentives for education that it is often too expensive and time-consuming for many taxpayers to simply sort them all out. As a result, many families without sophisticated advice and tax preparation from competent and highly trained practitioners simply forego using these incentives.

Recommendation: Congress should consider consolidating the various education benefits into three provisions:

1. An enhanced super 529 savings vehicle (including tuition prepayment plans), with elective payroll deductions;
2. A college tax credit with a single earnings phase out that would consolidate American Opportunity Credit/Hope Credit, Lifetime Learning Credit, and tuition and fees expenses; and
3. An expanded deduction for student loan interest.

Any savings from this consolidation of tax expenditures should be dedicated to making all three of these provisions available to as wide of an income group as possible.

Analysis: The proposal would simplify the tax code, reduce taxpayer burden, and would more fairly treat taxpayers of similar economic situations.

Earned Income Tax Credit (EITC)

Internal Revenue Code: Section 32.

The Problem: The EITC has increased work, reduced poverty, and lowered welfare receipts.[2] At the same time, it is one of the most complex parts of the Internal Revenue Code. Overpayments often result from the complexities of families' lives. The Department of Treasury estimates that 70 percent of improper EITC payments stem from issues related to the EITC's residency and relationship requirements; filing status issues; and issues relating to who can claim a child in non-traditional family arrangements.

Recommendation: Congress should simplify the EITC by making the definition of "qualifying child" for EITC consistent with current law governing a dependent child under Internal Revenue Code Section 152(c). The minimum age should be reduced to 18 for non-dependent taxpayers and the maximum age (currently under age 65) for EITC eligibility should be eliminated. Additionally, Congress

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[2] Council of Economic Advisers, "The War on Poverty 50 Years Later: A Progress Report," January 2014. Table 2 on page 27 highlights that the EITC and its sibling, the Child Tax Credit, lift more Americans out of poverty than any other program except Social Security.

should create a commission made up of Circular 230 practitioners and low-income advocacy groups to make recommendations on simplifying the residency rules to decrease the incidences of mispayments and to better reflect complex family arrangements.

Analysis: The proposal would simplify an extremely complicated section of the Internal Revenue Code, which should lessen the need for practitioners and the IRS to be involved in sorting out complex family relationships and thus lowering the incident of mispayments due to unintentional noncompliance. Expanding the eligible age range would create parity for similarly situated taxpayers.

International

Internal Revenue Code and U.S. Code: 31 U.S.C. § 5321(a)(5), sections 6038, 6038B 6038D, 6039F, 6046, 6046A, 6048(b).

The Problem: The reporting rules for American citizens living abroad are extremely complex and the penalties for noncompliance far outweigh the offense in most instances. Congress needs to reform these rules to make both the reporting and the inadvertent noncompliance less draconian.

Recommendation: The Internal Revenue Code should provide relief from the penalties in the following situations:

- The taxpayer has not filed a FinCEN 114 or IRS forms 926, 5472, 8938, 8865, 8858, 5471, 3520, or 3520A, but has reported all income from all sources.
- The taxpayer has not filed a FinCEN 114 or IRS forms 926, 5472, 8938, 8865, 8858, 5471, 3520 or 3520A, but there is zero balance due related to the various foreign entities.
- If the taxpayer should have filed a FinCEN 114 or IRS forms 926, 5472, 8938, 8865, 8858, 5471, 3520 or 3520A and there is a *de minimis* balance due as a result of the missing income, the penalty should be the greater of 20 percent of the tax due or $100.

Analysis: The proposal will mitigate the penalties associated with inadvertent noncompliance with the requirements of the Foreign Account Tax Compliance Act.

Self-Employed Health Insurance

Internal Revenue Code: Section 162.

The Problem: Self-Employed Health Insurance premiums are deductible as an adjustment to income in determining AGI, and not a business expense, absent a complex (and often expensive) employer-provided medical expense reimbursement plan.

Recommendation: Self-employed individuals should be able to deduct health insurance costs in determining net earnings subject to self-employment tax (Old-Age, Survivors, and Disability Insurance tax (OASDI) and Hospital Insurance (HI) tax).

Analysis: Self-employed individuals (who file Schedule C or F) cannot deduct their own health-insurance premiums as an ordinary and necessary business expense even though premiums paid for employees' health coverage are deductible.

Pension Simplification

Retirement and Deferred Compensation Plans

Internal Revenue Code: Sections 401(k), 403(b), 408(p), and 457.

The Problem: The proliferation of retirement plans that provide for taxpayer elective deferrals contain different rules and requirements. This has become a barrier for small businesses to provide retirement benefits to their employees as the small businesses compete with larger companies for the best employees of small businesses.

Recommendation: The Internal Revenue Code sections governing employee contribution plans elective deferrals should be simplified into a uniform simplified employee contributory deferral plan.

Analysis: The proposal would simplify the tax code and would more fairly treat taxpayers of similar economic situations.

Determination of Basis

Internal Revenue Code: Sections 401, 403(b), 408, 408A, 457.

The Problem: Depending on the type of retirement plan, there are separate rules for determining the basis of pension distributions.

Recommendation: Tax reform should include a uniform rule regarding the determination of basis in distributions from retirement plans.

Analysis: The proposal would simplify the tax code and would more fairly treat taxpayers of similar economic situations.

Early Withdrawal Penalties

Internal Revenue Code: Section 72(t).

The Problem: The rules governing the 10-percent penalty for early withdrawals, such as for college costs and first-time homebuyers, from qualified retirement plans are applied differently for IRAs and pension plans. Additionally, some plan types have larger penalties for early withdrawals. These rule differences can lead to confusion and penalties could be avoided if the exceptions to the 10 percent penalty are consistent for all qualified plans covered under § 72(t).

Recommendation: The penalty rules for early withdrawals should be standardized for distributions from all types of deferred accounts-qualified retirement plans.

Analysis: The proposal would simplify the tax code and will fairly treat taxpayers of similar economic situations.

1099/K–1 Reform

Brokerage Firm Filing Deadline

Internal Revenue Code: Section 6045.

The Problem: Even with the date change made by section 403 of the Energy Improvement and Extension Act of 2008, brokerage firms are resending updated forms 1099 throughout the tax filing season and occasionally, even later. These actions often necessitate changes and amendments or result in taxpayer requests for extensions of time to file, based on uncertainty of forms they have received.

Recommendation: The February 15th deadline for filing all forms 1099 from investment brokerages should be changed back to January 31st. Brokerage firms should be required to report the most accurate income and basis known as of January 31st. If insignificant corrections and adjustments are reported by brokerages subsequent to the January 31st deadline, there should be a *de minimis* safe harbor amount, under which the taxpayer is not required to file an amended or superseding return.

Analysis: The proposal would reduce burden and costs to taxpayers and reduce the government's burden of processing amended returns with insignificant changes.

Uniform 1099–B

Internal Revenue Code: Section 6045.

The Problem: Lack of standardization of the 1099–B in the brokerage industry causes confusion and misapplication of the information provided.

Recommendation: The IRS should provide a required uniform 1099–B for the brokerage industry.

Analysis: The proposal would lead to more accurate and complete information on the taxpayer's return. It would reduce taxpayer burden by reducing the number of IRS CP–2000 Notices mailed to taxpayers.

K–1 Simplification

Internal Revenue Code: Section 6031.

The Problem: Many unsophisticated taxpayers unwittingly invest in units of partnerships in real estate, oil and gas, timber, and such commodities and futures that generate unique deductions and credits that must be reported but rarely if ever affect the tax liability. These deductions and credits also add nothing to IRS's matching abilities.

Recommendation: IRS should be directed to review and simplify K–1 reporting for partnerships in real estate, oil and gas, timber, and commodities and futures for limited partners with a capital account of less than $50,000.

Analysis: The proposal would reduce complexity and taxpayer burden.

Indexing

Internal Revenue Code: All sections of the Internal Revenue Code.

The Problem: Many parts of the Internal Revenue Code are not indexed for inflation, eroding the value of numerous provisions over time.

Recommendation: The Internal Revenue Code should be amended as necessary to provide uniform indexing requirements.

Analysis: More uniform indexing of the Internal Revenue Code would ensure that taxpayers of similar economic situations would be treated fairly and provide stability.

Withholding

Internal Revenue Code: Section 3402.

The Problem: Employers withhold a percentage of employees' income from their paychecks, simplifying the remittance of taxes to the Treasury. Self-employed taxpayers must submit payment through estimated taxes.

Recommendation: The Internal Revenue Code should provide for optional withholding and reporting for independent contractors, partners and non-employee S-corporation shareholders. This could be done through a simple check-the-box election on the W–9 Form.

Analysis: The proposal would reduce taxpayer burden, would assist taxpayers in compliance with the "pay as you go" requirement, would reduce the number of end-of-year balance due amounts, and would more fairly treat taxpayers of similar economic situations.

IRS Future State, Practitioner Accounts

Internal Revenue Code: Section 6061(b).

The Problem: The IRS has developed online accounts for individuals that when fully functional, will allow taxpayers to see their transcripts, communicate through secure portals for webmail, and submit payments in full or by an installment agreement. Accounts for tax professionals are being developed at a much slower pace. Additionally, all powers of attorney and disclosure authorizations are still being submitted through the IRS Centralized Authorization File (CAF) using inked signatures while requiring manual input from IRS employees. It is NAEA's concern that the delay in modernizing online accounts for tax practitioners will discourage taxpayers from exercising all their rights for representation.

Recommendation: Congress should require the following:

1. The IRS should debut online accounts for tax practitioners at the same time as individual accounts.
2. Individual online accounts should display a Publication 1 equivalent when taxpayers utilize payment options in their accounts.
3. The IRS shall provide an electronic option for taxpayer authorizations of Circular 230 practitioners.
4. The IRS shall provide guidance on the use of electronic signatures for Forms 2848 and 8821 for Circular 230 practitioners.

Analysis: The proposal would ensure equal treatment for taxpayers being represented by tax practitioners and would ensure that taxpayers can fully exercise their rights under the Internal Revenue Code.

Minimum Standards for Unenrolled Tax Preparers

U.S. Code: Title 31, section 330.

The Problem: Unscrupulous unenrolled preparers are harming the integrity of the tax administration system through incompetency and fraud. The General Accountability Office, the Treasury Inspector General for Tax Administration and the Taxpayer Advocate have all commented on the need to provide minimum standards for tax preparation. Unfortunately, in *Loving v. Commissioner* and subsequent cases, the courts ruled that the Internal Revenue Service does not have authority to regulate tax return preparers under title 31. The case overturned the regulatory framework for registered tax return preparers and severely limited the agency's ability to regulate all individuals—even lawyers, certified public accountants and enrolled agents—in the preparation of tax returns.

Recommendation: Congress should override *Loving* and all subsequent cases relying on its holdings and provide specific authority for the IRS to require all non-credentialed paid tax preparers to meet minimum standards. Such standards should include passing a one time competency exam administered under the auspices of the Department of Treasury, requiring tax compliance background checks, setting continuing education requirements, and requiring compliance with strict ethical standards.

Analysis: Requiring minimum standards for all paid tax return preparers will increase compliance and the overall professionalism of the tax preparation industry. Establishing IRS's authority will help protect taxpayers, the tax administration system, and the U.S. Treasury.

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September 13, 2017

Submitted by: Kevin D. Quinn, Chair

On behalf of the National Volunteer Fire Council (NVFC), a registered 501(c)3 organization representing the interests of the more than 1 million volunteer firefighters and EMS providers in the United States, thank you for the opportunity to provide information regarding the impact that federal income taxation has on recruitment and retention incentives that many communities provide to their volunteer emergency responders as a reward for their service.

Eighty-five percent of all fire departments in the United States are staffed by all- and mostly-volunteer personnel. Those departments protect 35.1 percent of the nation's population. The NVFC estimates that the services donated by volunteer firefighters save taxpayers more than $30 billion annually. Thousands of communities across the nation, particularly in rural and suburban areas, would struggle to provide emergency services without their volunteers.

Between 1983 and 2015, the number of volunteer firefighters in the United States declined from 884,600 to 814,850, an 8 percent reduction. Perhaps more alarmingly, since 1987, the number of firefighters under the age of 40 serving communities of 2,500 or fewer residents dropped from 282,821 to 192,161 while the number of over-50 firefighters serving these same communities rose from 71,153 to 124,601. Whereas three decades ago the percentage of young firefighters used to be highest in small-town America, today nearly a third of all firefighters serving our smallest communities are over the age of 50.

The reason for this shift is largely due to demographics, what is happening in rural America, and the jobs market. People are less likely today to have the same job in the same community for their entire lives. This is especially true in rural America, because so many jobs have moved to more densely populated areas, or they've disappeared completely due to automation or offshoring. Additionally, there are more households today in which all adults present work outside of the home.

As a consequence of these changes, people are more likely to have to move at some point in their lives—and possibly several times—for employment. Additionally, young people from rural areas are more likely to have to move or commute in order to find work. This is very destabilizing for volunteer emergency services staffing, which historically was modeled on generational recruitment—children following their parents into the fire department.

With young people today more mobile than in the past, emergency services agencies are increasingly implementing formal recruitment and retention (R&R) programs in order to ensure adequate volunteer staffing. This is necessary to keep up with rising turnover, as people relocate out of communities, as well as to attract personnel who may not have ever considered volunteering as an emergency responder, or even be aware that the local fire/EMS agency is staffed by volunteers.

As part of a formal R&R program, many departments have begun to provide modest incentives to their volunteers as a reward for their service. The NVFC estimates that more than half of all volunteer emergency responders receive some type of incentive, including per-call payments, annual or monthly stipends, or non-monetary benefits such as clothing or goods and services. Volunteer incentives are typically modest—the NVFC estimates that for volunteers receiving incentives the average annual benefit is worth approximately $350—and most volunteers view benefits as a form of reimbursement for responding to emergencies in personal vehicles, replacing clothing to wear under protective gear and at training, along with other minor expenses.

Taxation of volunteer benefits can be confusing, in part because the very definition of "volunteer" isn't clear. The U.S. Department of Labor has ruled that personnel compensated at a rate of less than 20 percent of what a full-time paid employee performing the same functions would be compensated in the same jurisdiction should be considered "volunteers" rather than "employees." The Internal Revenue Service (IRS), however, does not recognize this distinction and has made it clear that even minor benefits provided to volunteers should be taxed as income.

The notion that volunteer benefits ought to be subject to federal income and payroll taxes has generally been slow to take hold in the volunteer emergency services community. Even today, the NVFC continues to hear from volunteer fire departments that are unaware that the benefits they provide are technically subject to taxation for a number of reasons, including:

– Interpreting the Labor Department's ruling to mean that because someone is considered a "volunteer" rather than an "employee" that benefits provided to that individual are not subject to income taxation.
– Viewing volunteer benefits as reimbursement and hence not subject to income taxation.
– Believing that if benefit amounts are small enough that there is no requirement that they be treated as taxable income or reported as such.
– Not viewing themselves as employers or the benefits they provide as income.
– Never having been audited or even contacted by the IRS and informed otherwise.

The federal tax code should be modified to allow local fire and EMS agencies to provide modest incentives to their volunteer personnel without incurring tax liability. Considering that the value of services rendered by volunteer emergency responders—on average, more than $37,000 per year per volunteer based on NFPA estimates—are worth far more than the benefits they receive, the notion that the federal government is owed tax on those benefits is counterintuitive.

In an attempt to simplify the application of federal tax law on volunteer benefits, legislation exempting property tax abatements and up to $360 per year of other types of benefits to volunteer firefighters and EMS personnel was enacted in 2007. In 2008, Congress passed legislation clarifying that exempted benefits are not subject to payroll taxes or withholding. Both of these provisions, commonly referred to as the Volunteer Responder Incentive Protection Act (VRIPA), expired at the end of 2010.

VRIPA increased the incentive value of volunteer benefits while easing administrative burdens associated with reporting and calculating withholding on volunteer benefits. Since VRIPA expired, volunteer fire departments in Florida and Virginia have been audited and fined by the IRS for improper reporting of benefits. This has had a chilling effect on departments providing benefits, which has in turn hampered R&R efforts at the local level.

S. 1238, the version of VRIPA introduced in this Congress by Senators Susan Collins and Ben Cardin, would make VRIPA permanent and increase the exempt amount from $360 per year ($30 per month of active service) to $600 per year ($50 per month of active service). A cost estimate developed by the Joint Committee on Taxation for identical legislation in the House of Representative (H.R. 1550) estimated that the cost to the federal government of enacting VRIPA would be $465 million total over the next 10 years (*see* enclosed cost estimate).

Volunteering has been part of American life since before our nation was founded. The volunteer spirit remains strong, but as society changes barriers to volunteering as an emergency responder have emerged that are making it increasingly difficult to recruit and retain personnel. On behalf of the NVFC, I urge the committee to include the language from S. 1238 in any legislation impacting the portion of the U.S. Code dealing with individual income tax. Enactment of VRIPA would give agencies that provide modest benefits a reprieve from having to report these payments as in come. It would also ensure that volunteers don't have to pay tax on what amounts to reimbursement for expenses incurred on behalf of the department.

Thank you for the opportunity to provide input to the committee on this important matter. If you have any questions, please do not hesitate to contact me directly, or you can follow up with Dave Finger, NVFC Chief of Legislative and Regulatory Affairs, at (240) 297–3566 or dfinger@nvfc.org.

Sincerely,

Kevin D. Quinn
Chair

Enclosure

Congress of the United States
JOINT COMMITTEE ON TAXATION
502 Ford House Office Building
Washington, DC 20515–6453
(202) 225–3621
http://www.jct.gov/

Honorable David G. Reichert
U.S. House of Representatives
1127 Longworth
Washington, DC 20515

Honorable John B. Larson
U.S. House of Representatives
1501 Longworth
Washington, DC 20515

Dear Mr. Reichert and Mr. Larson:

This is a response to your request dated April 12, 2017, for an estimate of H.R. 1550, the "Volunteer Responder Incentive Protection Act of 2017," which reinstates, increases, and makes permanent the exclusion for benefits provided to volunteer firefighters and emergency medical responders.

Present law requires all payments, stipends, property tax reductions, and other fee or tax reductions for volunteer firefighters and emergency medical responders to be treated as taxable income. H.R. 1550 will allow qualified payments, tax reductions, or fee reductions up to $50 per month of service to be excluded from taxable income. Qualified payments are any payment, reimbursement or otherwise, provided by a State or political division thereof, on account of performance of services as a member of a qualified volunteer emergency response organization.

H.R. 1550 is effective for taxable years beginning after December 31, 2017. We estimate that the bill would have the following effects on Federal fiscal year budget receipts:

Fiscal Years

(Millions of Dollars)

2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018–22	2018–27
−31	−43	−46	−47	−48	−49	−49	−50	−50	−51	−215	−465

NOTE: Details do not add to totals due to rounding.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

PRECIOUS METALS ASSOCIATION OF NORTH AMERICA

Written Testimony of Scott Smith, President

Chairman Hatch and Members of the Committee,

My name is Scott Smith, and I am the CEO of Pyromet, which is a privately owned precious metals manufacturer and refiner of silver, gold, and platinum group metals. Since 1969, Pyromet is a reputable name in precious metals and precious metals management. I also serve as President of the of the Precious Metals Association of North America (PMANA), and I am submitting this written testimony on behalf of our members. Our association's members are made up of refiners, manufacturers, traders, and distributors of products that are essentially comprised of precious metals such as gold, silver, platinum, and palladium. All of our members have a vested interest in tax reform—in particular, changes to the capital gains rate for investments in precious metal coins and bars.

Background

Right now, it is impossible to turn on the television without seeing an advertisement for investing in precious metals bullion coins and bars. These are great opportunities for people to include tangible assets into their portfolios. Since 1982, gains made on precious metals bullion have been taxed at the ordinary income rate due to language defining such bullion as a collectible. Congress has made numerous attempts to mitigate the effects of this capital gains treatment on precious metals. The Tax Reform Act of 1986 granted the American Eagle family of coins an exemption from the "collectible" definition and allowed them to be included as equity investments in Individual Retirement Accounts. Over a decade later, the Taxpayer Relief Act of 1997 created purity and custody standards that, if met, would exempt bullion coins and bars from the definition while also allowing them in IRAs. Furthermore, precious metals investment grade bullion products are purposely designed and produced in a way that excludes any assumption that they are rare or unique collectibles. Instead, investment grade bullion products are mass produced to be offered as investments strictly for their precious metal content.

Regulatory Inconsistencies

Since 1986, Congress and the U.S. Treasury have recognized the value of investing in precious metal bullion, thus making some exemptions from the "collectible" definition. However, the "collectible" definition remains for non-IRA investments in precious metals, and these investments are taxed at the ordinary income rate for collectibles with a maximum rate of 28%—a rate 40% greater than the capital gains rate for equity investments. To better understand this inconsistency, I want to briefly explain the different types of coins and the distinctions between them.

Coins—Function Versus Form

Coins belong to one of three basic categories that consider the coin's function and form. All coins are round in form. However, there is a critical difference in the concept of *form* and that of *function.* For example, while all airplanes have wings and tails and are designed to fly, different types of airplanes fulfill different functions. One wouldn't employ a Boeing 747 airliner to perform a fighter mission. Similarly, there are different categories of coins that have different roles, and each type is distinguished from the others by its *function* or purpose.

There are three basic categories of coins in the world today; each one serves a specific role.

1. Monetary Coins—These coins are part of a country's circulating currency that its citizens routinely use as money. Coins in circulation today contain no precious metal. The value of these coins (commonly referred to as their "legal tender" or "face" value) is set in law by government decree. In the United Sates, of course, these would include pennies, nickels, dimes, quarters, half-dollars, and now, the new "Sacagawea" dollar coin. They are used as a medium of exchange by which the general public effects everyday transactions, such as when they pay for candy bars, newspapers, parking meters, bridge tolls, etc. The purpose of these coins is to circulate in the general economy. They are not hoarded for their uniqueness or rarity, or because they have any premium value over their legal tender amount.

2. Rare Coins—These coins are commonly referred to as "numismatic" coins, that is, they are held by, valued and traded among hobbyists and coin collectors on the basis of their rarity and the quality of their physical condition. Typically, numismatic coins are old (sometimes ancient), and they may, or may not contain a precious metal. The market value of numismatic coins usually far exceeds either their face value or their precious metal content (if any). Their market values are determined by supply and demand factors that exist in the rare coin market for particular coins based largely on subjective judgments made about their scarcity and condition. Such coins may be held for enjoyment (*e.g.,* as in a hobby), or for investment purposes, or both, just as an antique rug or a rare painting may be purchased simply for the enjoyment of its owner, or specifically for its price appreciation potential. Thus, profits through capital gains may be realized when rare coins are sold, but because they are unique, their value determinations can vary and can be quite subjective.

3. Bullion Coins—Bullion coins are fungible, highly refined precious metals products, round in shape, and produced to exacting specifications in large numbers by numerous countries throughout the world specifically as precious metal investment vehicles. They are widely traded, highly liquid and their market values are globally publicized. Although they typically are ascribed legal tender status by the governments that mint them, bullion coins trade in the marketplace at or near the market price of the commodity they contain, which typically has no relationship whatsoever to the coin's legal tender, or "face" value. For example, earlier this year, a one-ounce American Eagle gold bullion coin having a U.S. *legal tender value* of $50, traded in the market place at $1,277.35, while gold itself was trading at a "spot price" of $1,239.85 per ounce. Thus, the price of the gold Eagle was at a $37.50 premium (3%) to the prevailing gold bullion price.

It is important to note that the premium charged for a bullion coin over and above the current "spot price" of the corresponding commodity it contains merely reflects the cost of insurance, transportation, handling, and storage, as well as the manufacturer's and dealer's profit, associated with the processing and sale of the coin. This premium is not a value ascribed to the coin as the result of any rarity or uniqueness considerations. In fact, bullion coins are purposely manufactured in sufficient quantities by their governments to ensure they are not "rare" or "scarce," but are as common as the many types of bullion bars available also produced by commercial refiners specifically for investment purposes. Therefore, bullion coins should be recognized and treated in the tax code as any other investment.

Recognizing precious metals coins and bars as investment products, *The Wall Street Journal* publishes each business day in its investment section, the market prices of gold, silver, platinum and palladium bullion as well as the prices the most widely traded bullion coins. Additional substantiation of the investment status of bullion coins and bars is evident in the fact that 21 states have removed their sales tax on bullion coins and bars.

Policy Proposal

Unlike rare coins—which include those most pursued by hobbyists and collectors—bullion coins are precious metal investment vehicles that are traded at the value of the commodity they contain. Since they are not rare, but rather mass produced specifically for investing, their status as a "collectible" for non-IRA investments is misaligned with their function and form. That is why I am requesting on behalf of the PMANA that Congress amend the Internal Revenue Code to treat gold, silver, platinum, and palladium in either bullion or coin form, in the same manner as stocks, bonds, and mutual funds for purposes of the capital gains rate for individuals.

Thank you, and I look forward to working with the Committee to ensure a reformed tax code that is fair to investors and promotes more investments in precious metal bullion coins and bars. If you have any questions, I am happy to meet with you and/or your staff to discuss this issue in greater detail. Thank you for the time and I hope the Committee will look closely at this issue and the impacts it has on American investors.