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BUSINESS TAX REFORM

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BUSINESS TAX REFORM

TUESDAY, SEPTEMBER 19, 2017

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

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Crapo, Roberts, Thune, Portman, Toomey, Heller, Scott, Cassidy, Wyden, Stabenow, Cantwell, Carper, Cardin, Brown, Bennet, Casey, Warner, and McCaskill.

Also present: Republican Staff: Mark Prater, Deputy Staff Director and Chief Tax Counsel; Tony Coughlan, Senior Tax Counsel; Eric Oman, Senior Policy Advisor for Tax and Accounting; and Jeff Wrase, Chief Economist. Democratic Staff: Joshua Sheinkman, Staff Director; Michael Evans, General Counsel; Tiffany Smith, Chief Tax Counsel; and Chris Arneson, Tax Policy Advisor.

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

The CHAIRMAN. During this morning's hearing, we will discuss ways to improve the business provisions of the U.S. tax code with an eye toward creating jobs and boosting wages for American workers and improving our country's overall business climate.

This hearing is part of our ongoing effort—following years of tax hearings and last week's hearing on individual reform—to draft and report comprehensive tax reform legislation later this year. Members of both parties recognize the need to reform the way we tax businesses in the United States.

As former President Obama noted when discussing his own framework for business tax reform, the current system, quote, "does too little to encourage job creation and investment in the United States while allowing firms to benefit from incentives to locate production and shift profits overseas," unquote.

As we all know, many elements of a particular business's tax burden depend on the company's organizational form. For example, C corporations are taxed at the corporate tax rate. According to a recent report by the Congressional Budget Office, the top Federal statutory corporate income tax rate has been 35 percent since 1993, and with State taxes added, the United States' average corporate statutory rate is the highest in the industrialized world, at more than 39.1 percent.

And, while some have noted that not all corporations pay the full statutory rate, the average effective tax rate of U.S. corporations is the fourth highest among G20 countries. According to a recent analysis by Ernst and Young, when you integrate corporate-level taxes and investor-level taxes, such as those on dividends and capital gains, U.S. tax rates are the second highest among developed countries. That last one is important, given that the United States taxes most corporate earnings that are distributed to shareholders twice—both at the corporate and the shareholder levels.

For the past few years, I have been working on a corporate integration proposal that, among other things, would allow businesses to deduct their dividends paid to help alleviate the double taxation problem. I view this as a complement to a statutory corporate tax rate reduction, not a substitute.

We held a few hearings on this topic last year, so I will not delve too deeply into the details at this time. For now, I will just say I continue to believe this idea, whether it applies fully or in some other limited way, can help address a number of the problems we are trying to solve with comprehensive tax reform. I look forward to continuing this conversation as the process moves forward.

It is also important to note that, while the U.S. corporate tax rate has remained unchanged for decades, the trend among our foreign competitors has been to lower corporate rates, making American businesses increasingly less competitive. This is not just a Republican talking point. This problem is widely acknowledged on both sides of the aisle. Even former President Bill Clinton, who signed into law the rate increase to 35 percent, recently argued the rate should now be lowered. I agree.

Our current business tax system—and the disparity between the U.S. corporate rate and our foreign competitors' corporate rates—has created a number of problems and distortions. For example, the current system slows economic growth by impeding capital formation, hindering wage growth and job creation, reducing productive capacity, and lowering the standard of living in the United States, all of which directly harm middle-class families and individuals.

The current system lowers returns on investment, creating a bias against savings and investment. This hinders the creation of wealth for Americans across the economic spectrum, including the middle class. The current system encourages corporations to finance operations using debt rather than equity, which increases the risks, particularly during times of economic weakness. The current system gives corporations incentives to shift income production and intangible assets, like intellectual property, from the U.S. to lower-taxed foreign jurisdictions, thereby eroding our tax base.

In tax reform, we need to address all of these problems and distortions, and many others as well. In particular, we need to lower the corporate tax rate to relieve the burdens the tax imposes on American workers, who, according to many economists, bear a significant part of the corporate tax.

We also need to reduce the burden on pass-through businesses whose earnings are reported and taxed on individual tax returns. These types of businesses include sole proprietorships, limited liability companies, partnerships, and S corporations. And we need to fix our international tax system so that American businesses can compete in the global marketplace without facing significant disadvantages simply because they are headquartered in the United States.

Each of these propositions is supported by people in both parties. Of course, when politics enter the equation, the story sounds much different. According to some, all Republicans want to do in tax reform is give tax breaks to the super-rich, have cushy portfolios for Wall Street bankers and more handouts for greedy corporations, all at the expense of middle-class workers and families. Those types of claims may play well to political bases, but they do not align with reality.

As I noted in our hearing last week, virtually all of our current tax reform ideas are aimed squarely at helping the middle class as well as low-income families. Our chief goals, particularly in business tax reform, are to increase economic growth, create new jobs, grow wages for the employees of both large and small businesses, expand opportunities for all Americans, and improve standards of living for everyone in the United States.

The proof, I suppose, will be in the pudding. As the committee works through this process with those goals in mind, I believe we will be able to demonstrate why those in the middle class should feel as though they have a stake in this discussion and how these ideas to reform our current system will help. Let us keep in mind that the status quo—sluggish economic growth, stagnant wages, and decreased workforce participation—has not exactly been doing the middle class any favors. The case for tax reform should therefore be easy to make.

I want to reiterate what I said last week, namely that this committee will be the starting point for any tax reform legislation that is considered in the Senate. While I expect we will continue to hear more arguments about secret tax plans written behind closed doors, this committee is going to consider tax reform through regular order. That applies to both the drafting and the reporting of any tax reform bills.

As I also said last week, I hope this process is bipartisan. As with individual tax reform, there are many areas of business tax reform where thoughts and interests of both Republicans and Democrats overlap. There is fertile ground for bipartisan agreement on this, and I hope we can take advantage of this historic opportunity together.

I know that my friend Ranking Member Wyden shares these broad objectives, and I appreciate that. In fact, he has put forward his own tax reform proposals in the past, likely with these same goals in mind. And at the end of the day, we should all at the very least agree that the current tax system is broken and the current state of our economy should not be accepted as the new normal.

I look forward to a robust discussion of these issues here today as well as some acknowledgments of the bipartisan agreement that exists on these matters.

So with that, I will turn to Senator Wyden for his opening remarks.

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

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

Senator WYDEN. Thank you very much, Mr. Chairman. I am going to have to do a little committee-hopping here in the next hour, so I am going to be brief. And before I get to the substance of today's hearing, I just need to talk briefly about what is coming down the pike for this committee, both here and on the floor.

And as I told you, Mr. Chairman, the remarks I am going to make now do not in any way affect my admiration for you, our friendship, and the fact that we just moved ahead on a very important CHIP bill, the Children's Health Insurance Program bill. I just want to set out my comments about what happened last night.

Last night the majority announced, without consulting the minority, that the Finance Committee is going to hold a hearing on the Graham-Cassidy-Heller health-care bill. I want to make clear: I believe that this is an abomination. It is an abomination of the process, it is an abomination of the substance, and it is an abomination of the history of this storied committee.

First of all, this bill is a prescription for suffering and disastrous consequences for millions of our people. Second, the Budget Office has informed Congress that it will be several weeks at the very least before it can provide real estimates for the bill. So this means the majority is going to charge ahead with a radical, destructive transformation of American health care with the American people in the dark.

This bill is going to be a few roll-call votes away from the President's desk. And yet, Republicans here in the Senate do not have answers to the key questions: What is going to happen to the premiums paid by the American people? What is going to happen to their coverage?

The idea, the proposition that a bill this destructive, this far-reaching, can swing through the Senate Finance Committee for a single hearing on a Monday morning and hit the Senate floor a day or two later makes a mockery of the legislative process that Senator McCain so eloquently urged us to return to.

Furthermore, this abomination of a process stands in sharp contrast to what we have been able to achieve with respect to the Children's Health Insurance Program. What a sad commentary on the times, that when the committee ought to be celebrating a big victory for something like 9 million kids, for millions of families, the Graham-Cassidy-Heller bill threatens the health care of millions of children and families.

Second point: reconciliation relies on secrecy, brute power, and speed to ram purely partisan bills through the Senate. And it is a train wreck to do it on health care.

I think we have to note, as we start this hearing, that Leader McConnell is committed to Reconciliation Round Two on tax reform when we want, on this side of the aisle, to have colleagues working together in a bipartisan way. And as the chairman noted graciously, I have written two full bipartisan bills. Leader McConnell says we are going to have another partisan bill, another completely partisan bill, with respect to tax reform. And I think that too is a prescription for trouble.

So the details that leak out of these "Big Six" meetings, in my view, suggest that what is under way is an unprecedented tax give-away for the most fortunate and the biggest corporations in the country. The centerpiece could be a $2-trillion loophole dealing with something called pass-through status.

Now, pass-through status is supposed to be all about small businesses, you know, the person who is running a cleaners or running a restaurant. There is no question those small businesses fuel local economies and hire the most workers. They surely need a boost in tax reform. But any tax change that allows tax cheats to abuse pass-through status by self-declaring to avoid paying their fair share and dodge Social Security taxes would be worse than what is on the tax books today.

The day the pass-through loophole bill becomes law would be Christmas morning in America for the tax cheats. It would make a mockery of the Trump pledge that, quote, "The rich are not going to gain at all with this plan." And that is just one element of what is on offer.

The bottom line for me as we move to this crucial discussion is, it is time for the Congress to take the lies out of the corporate tax rate in America. Many of the biggest corporations in the country employ armies of lawyers and accountants who know every single one of the tax tricks. And they use them all to winnow down their tax rates to the low teens, to single digits, even zero. So the Congress cannot pair a big corporate rate cut with a plan to enshrine a vast array of loopholes that lets corporations off the hook for paying their fair share. That is, in my view, a surefire way to heap an even heavier burden on the middle class.

So I look forward to discussing these issues, Mr. Chairman. As I indicated, I am going to have to be out for a few minutes, but I look forward to the discussion, and I thank you for the chance to make this statement.

The CHAIRMAN. Well, thank you, Senator Wyden.

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

The CHAIRMAN. Some of our committee members have requested a public hearing to examine details of the Graham-Cassidy health care proposal. A hearing will allow members on both sides to delve deeper into the policy and gain a better understanding of what the proposal is intended to achieve. So we are going to have a hearing next week on this matter. I believe that members will benefit from a public discussion and examination of these issues.

Yet, even though their requests have been heard and a hearing is on the schedule, some members are still unsatisfied. I am not sure what else we can do on this matter to address every complaint. For today, our hearing is on business tax reform, and I hope we can focus these proceedings on that issue.

Having said that, I would like to welcome each of our witnesses to our hearing today. We all appreciate your willingness to testify and answer questions today. Hearing each of your perspectives on tax reform will be critical to our process.

First, we will hear from Mr. Scott A. Hodge, the president of the Tax Foundation in Washington, DC, where he has worked for the past 25 years. Before joining the Tax Foundation, Mr. Hodge was director of tax and budget policy at Citizens for a Sound Economy. He also spent 10 years at The Heritage Foundation as a fellow analyzing budget and tax policy. Before that, Mr. Hodge started his career in Chicago, where he helped found the Heartland Institute in 1984. He holds a degree in political science from the University of Illinois at Chicago.

Second, we will hear from Dr. Donald B. Marron, an institute fellow and director of economic policy initiatives at the Urban Institute. From 2010 to 2013, Dr. Marron led the Urban-Brookings Tax Policy Center. Prior to joining Urban, Dr. Marron served as a member of the President's Council of Economic Advisers and Acting Director of the Congressional Budget Office. He has also taught at the Georgetown Public Policy Institute and the University of Chicago's Graduate School of Business. Dr. Marron studied mathematics at Harvard College and received his Ph.D. in economics from the Massachusetts Institute of Technology.

Next, we will hear from Mr. Troy K. Lewis, the immediate past chair of the Tax Executive Committee of the American Institute of Certified Public Accountants in Washington, DC. Mr. Lewis currently teaches at Brigham Young University in Provo, UT. He is in practice as a managing member of Lewis and Associates CPAs, LLC in Draper, UT. He obtained his master's of accountancy and bachelor's of science in accountancy from Brigham Young University. He is also a certified public accountant and a chartered global management accountant.

Last but not least, we will hear from Mr. Jeff DeBoer, the founding president and CEO of the Real Estate Roundtable, where he has served since 1997. Mr. DeBoer also serves as the chairman of the Real Estate Industry Information Sharing and Analysis Center as well as chairman of the National Real Estate Organizations. Mr. DeBoer has also served as co-chairman of the advisory board of the RAND Corporation Center for Terrorism Risk Management Policy and was a founding member of the steering committee of the Coalition to Ensure Against Terrorism. Mr. DeBoer holds degrees from Washington and Lee University School of Law and from Yankton College. He is a member of the Virginia Bar Association and the American Bar Association.

We want to thank all of you again for coming today, and I look forward to hearing your remarks.

Mr. Hodge, we will begin with you, so if you will please begin, that will be great.

STATEMENT OF SCOTT A. HODGE, PRESIDENT, TAX FOUNDATION, WASHINGTON, DC

Mr. HODGE. Well, thank you, Mr. Chairman and Ranking Member Wyden. It is good to see you and all the members of the committee.

I commend you for taking on the challenge of reforming America's business tax code, especially the task of overhauling our corporate tax system. The most important thing that Congress and the administration can do to boost economic growth, lift wages, create jobs, and make the U.S. economy more competitive globally is overhaul our business tax system.

The Tax Foundation's extensive economic research and tax modeling experience suggest that the committee should have four priorities in mind when you are reforming the corporate tax system. We call these the four pillars of corporate tax reform. First, provide full expensing for capital investments. Second, cut the corporate tax rate to a globally competitive level, such as 20 percent. Third, move to a competitive territorial system. And fourth, make all three of these priorities permanent.

And while many of you and many in the business community may see some of these policies in conflict or competing for space in the tax plan, we see these pieces as complementary and essential, not in conflict. In our view, cutting the corporate tax rate and moving to a territorial system are essential for restoring U.S. competitiveness and reducing the incentives for profit-shifting and corporate inversions. These measures are also important for defining and reclaiming the U.S. tax base. Right now, the European Union and the OECD are proposing policies such as a new turnover tax on digital companies that are directly aimed at raising taxes on U.S. multinationals.

Expensing, we believe, is key to reducing the cost of capital in order to revitalize U.S. capital investment, which, in turn, will boost productivity and wages. Thus, a good tax plan should include all three of these policies, because they will not only boost economic growth, but they will do so in a way that leads to higher wages and living standards for working Americans.

However, these gains are not possible if the policies are made temporary. Temporary tax cuts deliver temporary results, whereas permanent tax reform delivers permanent economic benefits.

It is hard to generate public support for corporate tax reform, I know, because most people do not see how it benefits them. Corporate tax reform may not put cash in people's pockets in the same way a tax credit might, but it can have a powerful effect on spurring economic growth while lifting after-tax incomes and living standards.

As just an example, we used our Taxes and Growth Dynamic Tax Model to simulate the long-term economic effects of cutting the corporate tax rate to 20 percent and moving to full expensing for corporations. Our model indicates that these two policies combined would increase the level of GDP by 3.4 percent, lift wages by an average of 3.8 percent, and create more than 860,000 new jobs. And when we account for all of these economic factors, we find that the lower corporate tax rate and full expensing combined would boost the after-tax incomes of all Americans by an average of 5.2 percent. Pretty good.

And one last thing to consider about expensing. It does something that no rate cut can. It eliminates pages and sections from the tax code, saving businesses more than 448 million hours of compliance time and more than $23 billion in compliance costs each year.

The great economist Thomas Sowell once said that there are no solutions, there are only tradeoffs. And I am sure you are all discovering that now in looking at corporate tax reform.

First, the math is very hard. Contrary to what some people believe, there are not as many loopholes in the corporate tax code as many think, and so you will likely have to think outside the box if you want corporate tax reform to be revenue-neutral.

Second, the economics of tax reform must be at the forefront of your decision-making. If you make the wrong choice in the base broadeners you choose to offset your tax cuts, you can neutralize all the benefits that you are trying to achieve through the reforms.

These are the challenges, and there will be hard choices ahead of you. But corporate tax reform done right is key to growing the economy, boosting family incomes, and making the U.S. a better place to do business in and do business from.

So remember the four pillars of corporate tax reform: full expensing, lower corporate tax rate, a territorial system, and permanence. Those are the right policies to make this tax reform effort a lasting success.

So, Mr. Chairman, thank you very much for the opportunity to share these ideas. I look forward to any questions that you may have.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. Dr. Marron, we will turn to you.

STATEMENT OF DONALD B. MARRON, Ph.D., INSTITUTE FELLOW, URBAN INSTITUTE AND URBAN-BROOKINGS TAX POLICY CENTER, WASHINGTON, DC

Dr. MARRON. Great, thank you. Chairman Hatch, Ranking Member Wyden, members of the committee, thank you very much for inviting me to discuss business tax reform.

America's business tax system is needlessly complex and economically harmful. Thoughtful reform can make our tax code simpler, it can boost American competitiveness, it can create better jobs, and it can promote shared prosperity.

But tax reform is hard. Meaningful reforms create winners and losers, and you will likely hear more complaints from the latter than praise from the former. I feel your pain. But at the risk of adding to it, my testimony today makes eight points about business tax reform.

First, thoughtful reform can promote economic growth, but we should be realistic about how much. More and better investment boosts economic activity over time. The largest effects will occur beyond the 10-year budget window. If reform is revenue-neutral, revenue-raisers may temper future growth. If reform turns into tax cuts, deficits may crowd out private investment. Either way, the boost in the near term may be modest, and dynamic scoring will thus play only a small role in paying for tax reform.

Second, the corporate income tax makes our tax system more progressive. The corporate income tax falls on shareholders, investors more generally, and workers. Economists debate how much each group bears. Workers are clearly the most economically diverse, but they include highly paid executives, professionals and managers, as well as rank-and-file employees. The bulk of the corporate tax burden thus falls on people with high incomes, even if workers bear a substantial portion.

Third, workers would benefit from reforms that encourage more and better investment in the United States. In the long run, wages, salaries, and benefits depend on worker productivity. Reforms that encourage investment and boost productivity would thus do more to help workers than those that merely increase shareholder profits.

Fourth, taxing pass-through business income at preferential rates would inspire new tax avoidance. When taxpayers can switch from a high tax rate to a lower one, they often do so. Kansans did so when their State stopped taxing pass-through income. Professionals use S corporations to avoid payroll taxes. Investment managers convert labor income into long-term capital gains. Congress and the IRS can try to limit tax avoidance, but the cost will be new complexities, arbitrary distinctions, and new administrative burdens.

Fifth, capping the top tax rate on pass-through business income would benefit only high-income people. To benefit, taxpayers must have qualifying business income and be in a high tax bracket. Creating a complete schedule of pass-through rates could reduce this inequity, but it would expand the pool of taxpayers tempted by tax avoidance.

Sixth, taxing pass-through business income at the corporate rate would not create a level playing field. Pass-through income faces one layer of tax, but corporate income faces two, at the company level and again at taxable shareholders. Taxing pass-throughs and corporations at the same rate would favor pass-throughs over corporations. To get true tax parity, you could apply a higher tax rate on pass-through business income, you could levy a new tax on pass-through distributions, or you could get rid of shareholder taxes.

Seventh, it is difficult to pay for large tax cuts and business tax rates by limiting business tax breaks and deductions. Eliminating all corporate tax expenditures, except for deferral, for example, might be able to get a corporate rate down to 26 percent. You could try to go lower by cutting other business deductions, such as interest payments, but deductions lose their value as tax rates fall. To pay for large rate reductions, you will need to raise other taxes or introduce new ones. Options include raising taxes on shareholders, a value-added tax or close variant like the destination-based cash-flow tax, or a carbon tax.

Finally, making business tax cuts retroactive to January 1, 2017 would not promote growth. Retroactive tax cuts would give a windfall to profitable businesses. That does little or nothing to encourage productive investment. Indeed, it could weaken growth by leaving less budget room for more pro-growth reforms. Another downside is that all the benefits would go to shareholders, not workers.

Thank you again. I look forward to your questions.

The CHAIRMAN. Thank you. Thank you so much.

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

The CHAIRMAN. Okay. We will go next to Mr. Lewis.

STATEMENT OF TROY K. LEWIS, CPA, CGMA, IMMEDIATE PAST CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROVO, UT

Mr. LEWIS. Chairman Hatch, Ranking Member Wyden, members of the Committee on Finance, thank you for the opportunity to testify on behalf of the AICPA.

As the committee tackles this rare opportunity to enact bold, pro-growth business tax reform, we urge Congress to take a holistic approach to provide tax reform to all of America's businesses. Fair and equitable tax reform will drive economic growth and enhance the competitiveness of all types of American businesses, not only in the U.S., but also abroad.

The AICPA is a longtime advocate for an efficient and pro-growth tax system based on principles of good tax policy. We need a tax system that is fair, stimulates economic growth, has minimal compliance costs, and allows taxpayers to understand their tax obligations. These features of a tax system are achievable if principles of good tax policy are considered.

Today I would like to highlight a few tax reform issues that directly impact businesses and their owners. First, we are concerned with and oppose any new limitations on the use of the cash method of accounting. The cash method is simpler in application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving their income. Forcing businesses to switch to the accrual method unnecessarily discourages business growth, increases compliance costs, and imposes financial hardship on cash-strapped businesses.

Next, tax relief should not mean a rate reduction for only C corporations. Congress should encourage or at least not discourage the formation of pass-through entities. Inequities would also arise from having significantly different income tax rates for business income based on an overly simplistic approach, such as one centered solely around the structure, sector, or the general nature of the business's activities.

For example, excluding professional service firms from the benefit of a lower business rate reflects a view of the service industry that does not represent the current global environment. In today's economy, professional service firms are increasingly competing on an international level with businesses organized as corporations. They also require a significant investment and rely on the contribution of employees to generate a substantial portion of the revenue. Artificially limiting the use of a lower business rate, regardless of the industry, would penalize a business for operating as a pass-through entity. Professional service firms are an important sector in our economy and heavily contribute to the Nation's goals of creating jobs and better wages. Without the benefit of a fair and consistent rate reduction for all businesses, including pass-through entities, the incentive to start or grow a business is diminished, with a corresponding loss of jobs and reduction in wages.

We recognize that providing a reduced rate on active business income will place additional pressure on the distinction between profits of the business and compensation of the owner operators. We recommend codifying traditional definitions of reasonable compensation and provide, if necessary, additional guidance from Treasury and the IRS.

If Congress moves forward with a fixed percentage split for business income, such as treating 70 percent of pass-through earnings as employment income and 30 percent as return of capital, we recommend making the proposal a safe harbor rather than a hard-and-fast rule. A safe harbor would promote simplicity for many businesses without sacrificing fairness for others. It would also provide a uniform treatment among closely held business entity types.

Another important issue is the ability to deduct interest expense. Business owners borrow to fund operations, working capital needs, equipment acquisition, and even to build credit for future loans. These businesses rely on financing to survive. Equity financing for many startup businesses is simply not available. At a minimum, we should not take away or limit this critical deduction for many small and mid-sized businesses that, with little or no access to equity capital, are often forced to rely on debt financing.

Finally, we encourage you to enact mobile workforce legislation, such as the bill introduced by Senator Thune. The burden of tracking and complying with all the different State payroll tax laws is complex and costly, particularly for small employers. The mobile workforce legislation provides a uniform national standard for nonresident State income tax withholding and a de minimis exemption from State income tax for non-resident employees.

Thank you for the opportunity to testify, and I will be happy to answer any questions you may have.

The CHAIRMAN. Well, thank you. We are grateful for your testimony.

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

The CHAIRMAN. Let us go to our final witness, Mr. DeBoer, and we will listen to you.

STATEMENT OF JEFFREY D. DeBOER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE REAL ESTATE ROUNDTABLE, WASHINGTON, DC

Mr. DEBOER. Good morning. Tax reform's impact on the commercial real estate industry will have wide-ranging effects on the economy, job creation, and the overall GDP. And I am honored to be here today to talk with you about this issue.

But it is not the first time that our industry has been before this committee and talked about tax reform. In 1981, Congress provided our industry with very aggressive tax incentives. These tax incentives spawned a robust tax shelter industry and resulted in the development of millions of buildings that had no tenants.

In 1986, Congress rightly eliminated these tax shelter provisions; however, the combination of these actions caused severe dislocation in real estate markets nationwide, caused great numbers of lost jobs, resulted in countless bankruptcies, and many people believe that it ultimately led to the demise of the savings and loan industry.

It took years for the economic pain to work through the system. Our industry steadily has recovered. And with congressional assistance, the Federal taxation of real estate investment today is much closer to matching the economics of the investment. As a result, the commercial real estate industry today is estimated to provide about 20 percent of the Nation's GDP. Our industry now employees millions of Americans, provides local governments with their largest revenue source, and plays a key role in the retirement savings and wealth creation of Americans. Importantly, commercial real estate markets today are largely in balance, where supply only modestly exceeds demand.

Now, despite our industry's relatively positive health, we know the underlying economy can and should grow more rapidly. Properly designed tax reform can spur overall job creation, encourage more robust business expansion, improve the standard of living for all Americans, and result in sustainable GDP increase.

The first step should be reducing the tax on all job-creating businesses. This action should not be limited to corporate income but should also include income from pass-through businesses. And I want to pledge to Senator Wyden that our industry and our organization will work very hard to make sure that there are not games played on compensation earned.

Pro-growth tax reform should also encourage and reward risk through capital gain. And capital gain should continue to recognize that it is not just cash that is put in an investment that should be rewarded. Some concepts, however, may have unintended consequences. For example, our capital markets today are the envy of the world. Entrepreneurs are able to access debt amounts needed to provide their businesses with flexibility to build, operate, and grow their businesses. We should continue that and not end the deduction for business expenses.

The proposal to expense assets is troubling to us, because it is suggested to apply to structures. We think that carries great potential negative consequences. Expensing structures would obviously encourage a lot of development, but we are concerned that this development would not be supported by underlying demand. And such un-economic development is a false indicator of economic strength and will badly distort markets.

This is not to say, however, that the current cost recovery system is correct for our industry. We think it should be shortened. And MIT has reviewed a wealth of data regarding buildings, and their findings suggest that the proper economic life of buildings is 20 years. We believe a 20-year life twinned with the continuation of the interest deduction will spur sustainable development and sustainable GDP expansion.

The deduction for Federal, State, and local property tax payments should continue. We think that repeal will cause many businesses to leave our urban areas, and we reject that idea. We believe the like-kind exchange rules also should be continued. We think they are a positive part of the economy.

I would like to say that in 2015 Congress took a very positive step in the PATH Act regarding the taxation of foreign investment in U.S. real property. We urge you to now take another step and repeal that entirely.

There is one final item that I would like to add, and that is that we would urge you to consider an infrastructure initiative of some type in tax reform. Action in this area is badly needed. It would create jobs. And if it is done correctly, and by correctly I mean to understand the transportation revolution that is going on in our country and where we will be going as far as transportation needs and mobility in the future, and if we do it, if Congress and policymakers do it the correct way, it not only would create jobs but increase productivity for workers and our businesses.

We have submitted a detailed statement, and I would be happy to respond to any questions about it or my comments today. Thank you.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. Thank you so much, all four of you. We really appreciate you taking the time and putting in the effort to come and testify to us today. And we will pay strict attention to your statements.

I might add that today is Senator Tim Scott's birthday. I do not think he looks a day over 29 and makes the rest of us look pretty old, I will tell you.

Senator SCOTT. I am very appreciative, sir.

The CHAIRMAN. Well, we are grateful to have you on the committee. You add a great deal to our committee, as do the other members.

Well, let me start with you, Mr. Hodge. In your testimony, you note that the Tax Foundation is generally supportive of corporate integration. Of course, corporate integration is an idea that I, along with my staff, have been exploring for several years now.

In your written testimony, you note that reducing the corporate tax rate to 20 percent increases economic growth in the long run by 3.1 percent and results in 592,000 full-time-equivalent jobs. And corporate-only expensing achieves a very similar result: an increase in economic growth by 3 percent, resulting in 575,000 full-time-equivalent jobs. Now, these projections are impressive.

What struck me as very interesting is that in the Tax Foundation's 2016 book *Options for Reforming America's Tax Code,* almost identical economic growth and job projections occur with corporate integration, that is, allowing a corporation to deduct dividends.

The Tax Foundation estimated economic growth of almost 3 percent in the long run, 2.9 percent to be precise, and 535,000 full-time-equivalent jobs. And of course, corporate integration would eliminate the two levels of tax on corporate earnings and bring the tax treatment of debt and equity closer into alignment, which would reduce, if not eliminate, a lot of the distortions and inefficiencies of the current system.

Would you share with us the Tax Foundation's views on corporate integration in general and the dividends paid deduction approach in particular?

Mr. HODGE. Well, thank you, Mr. Chairman. You know, I was looking through the Tax Foundation's archives and came across a 1977 Tax Foundation publication by Marty Feldstein—whom I think you know well—on corporate integration. And since that time, there have been no fewer than a dozen corporate integration proposals that have come out of either Congress or the White House. And this is an issue of longstanding study and, unfortunately, we have yet to see the kind of action that I think is necessary to remove the double taxation of corporate income and make business taxation more equitable.

We believe that business income should be taxed only once and at the same rate. And as you noted, in our analysis it has the dramatic effect of lowering the effective corporate tax rate and having a substantial impact on long-term economic growth. But as you mentioned, rightly I think, it also improves or equalizes the treatment of debt and equity financing and, as a result, makes the economy much, much more efficient.

And I think a dividends paid deduction is a very thoughtful way to approach this. After all, companies get to deduct their interest costs; why should they not get to deduct the dividends that they pay to shareholders?

And I think it is certainly an approach that ought to deserve the attention and consideration of the committee, but also, as you move forward on fundamental tax reform, ought to be a nice complement to the broader corporate tax reform efforts.

The CHAIRMAN. Well, thank you.

Mr. Lewis and Mr. DeBoer, you both included in your written statements concerns regarding limitations on the deductibility of interest expense. Mr. Lewis, your testimony laid out concerns for small businesses and services businesses. Mr. DeBoer, your testimony laid out the potential and significant negative effects on the real estate industry of such a limitation.

However, we frequently hear how the current tax treatment of debt and equity financing leads to overleveraging of businesses, and limiting the deductibility of interest expense brings the tax treatment of the two more in sync.

I would like your respective thoughts on that, Mr. Lewis and Mr. DeBoer, if you could do that for us.

Mr. LEWIS. Okay, I will take a crack at it first. Equity financing for many startups and small, mid-sized businesses is simply not available. I think you have to start with that notion. So, while the points that you just made are there, the combination of those and taking away an interest expense deduction will put more burden on those small businesses.

I mean, the reality is that large businesses have access to the equity markets, the capital markets, and small businesses do not. So many of our businesses, particularly the growth businesses, the entrepreneurial businesses, are those businesses that rely on debt financing.

Tax laws should not discourage the formation of businesses. The formation of new businesses is one of the best aspects that we have in the U.S. economic system, and I think it should continue.

The CHAIRMAN. Thank you.

Sir?

Mr. DEBOER. Mr. Chairman, the issue of overleverage, I think, is really one that should be examined on an individual-by-individual basis. If there is overleverage, it is a problem with the regulators who were supposed to be determining whether someone had too much leverage, and we would prefer that the issue be dealt with there, not through the tax code.

The use of debt is very, very important for all businesses, not just startup businesses and not just small businesses, but all businesses that need this kind of flexibility to use debt.

Debt, by the way, allows entrepreneurs to retain more control over their business operation. If they have equity, they give up control of some of their business. They retain more control over their business operations by using debt. It is something that historically has been recognized as a cost of doing business, like other costs of doing business. And we really see no reason to adjust it through the tax code.

That is not to say that we think that people should be overleveraged or that businesses should be overleveraged. They should not be. There should be governors on that. And there are other parts where the government should act.

By the way, in the real estate industry, from a macro point of view, I believe our industry is now levered at about 60 percent. Publicly traded REITs, for example, are levered at even lower amounts, 40 or 45 percent on average.

So we are very mindful of the problems with overleverage, but it is really a problem of whether the borrower itself is able to repay the amount, and it might be a low amount of leverage that they cannot handle while others can handle higher amounts.

Thank you for the question though, sir. It is very, very important to have access to debt for the economy to continue to grow.

The CHAIRMAN. Well, thanks to both of you.

Senator Grassley?

Senator GRASSLEY. For anybody or all of you: as part of a pro-growth tax reform, there has been considerable debate over what is more important, lower rates or expensing.

Mr. Hodge and Dr. Marron, especially you two, could you both elaborate on how you see the tradeoff between expensing of depreciation and lower rates? For example, do you view it as acceptable to lengthen depreciation to help finance lower rates?

Mr. HODGE. Well, I will start out with the first part of that, Mr. Grassley. We see expensing as the most powerful policy change that you can make to improve economic growth. And, on an apples-to-apples basis, our models show that full expensing delivers twice the economic growth than a comparable rate cut, and that is because it really affects new investment whereas a rate cut, a corporate rate cut, affects both new and old capital, new and old investment, and so its benefits get distributed a little more broadly.

But to the second point, I think we have to look back at the tax reform proposal that Chairman Camp put forward a few years ago, which lengthened depreciation lives in order to finance or offset the revenue lost from a corporate rate cut. And what we found—all the models, the Joint Committee on Taxation model, the Tax Foundation model, showed that lengthening depreciation lives raised the cost of capital to such an extent that it offset the benefits of a lower corporate tax rate on the other hand. And it ended up as an economic wash.

And I think you need to be extremely careful in looking at your offsets when you are looking to offset the corporate rate cut.

Dr. MARRON. So my thoughts are going to be very, very similar, that if you focus on expensing, what you are doing is, you are providing incentives for new investment, which is the thing that is going to be most beneficial for the economy—and I want to emphasize it is also going to be most beneficial for workers.

The research that my colleagues at the Tax Policy Center have done suggests that if you focus on reductions that encourage investment, you get more of the benefits flowing to workers and relatively less of it being focused on shareholders.

That said, with a 35-percent top rate, you could make very good arguments for bringing that down as well, as part of the concerns about the competitiveness of our tax system.

But as Scott just said, if your strategy is to reduce the corporate rate and then make depreciation and write-offs less favorable, what you are going to see in all the macro models is that that is going to very much limit any growth benefit you get.

Senator GRASSLEY. Okay. I am going to ask the same two people something that Senator Hatch discussed with the others, because I want your opinions on it, and that is consideration of restrictions, whether they should be imposed on the ability to deduct interest.

As you know, the House Blueprint generally eliminates interest as a business expense in exchange for going to a full expensing on capital assets.

So for the two of you, should any restriction on the deductibility of interest be considered to finance lower rates or faster depreciation?

Dr. MARRON. I will go first on this one. There are two great schools of how you should tax, right? There is the income tax school and the consumption tax school. So in the income tax school, interest is an expense—you ought to be able to deduct it—and then depreciation ought to follow the economic depreciation of assets over time. In the consumption tax view of the world, you should be able to expense everything immediately, and you should not get any write-off for interest.

We have a system that is somewhere in between those, where we have accelerated depreciation, but we allow interest deductibility. And the challenge you have there is that you can actually over-encourage investment. You can create negative effective tax rates on investment. You can have some of the problems that Jeff mentioned that happened in the 1980s. If you go too far in making investment favorable, but allow full deduction of interest, you can end up with excessive investment in certain sectors.

And so I am very, very open to reducing interest deductibility if it is being paired with making depreciation more favorable. That moves in the direction of a consumption tax; that is a logical and consistent way to design a tax system.

Mr. HODGE. I would echo much of what Donald has said. And I think that our models show that when you eliminate interest deductibility, it not only raises about $1.2 trillion, but it does so in perhaps a less-harmful way than other options. And thus, when paired with a corporate rate cut or full expensing, you get the maximum amount of benefits from those policies with the least amount of harm on the other side.

There are also other advantages to eliminating the interest deductibility when it comes to perhaps reducing the amount of earnings stripping that we see, where foreign multinationals load up debt here on their domestic subsidiaries and then strip income out of the U.S. tax base.

There are other issues that we have talked about in terms of overleveraging and so forth, so there are many advantages to it. But we do understand that some industries are perhaps over-reliant on it and it could be disruptive. But it is one of the tradeoffs that will have to be made in order to get economic growth on the other side of the equation.

Senator GRASSLEY. Thanks to both of you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Carper?

Senator CARPER. Thanks, Mr. Chairman.

I want to add to your birthday wishes to Tim Scott. It is great to serve with you, Tim, and happy, happy birthday.

You are too young to remember a great song by Conway Twitty, and this last weekend I just happened to be listening to the radio driving around, and I heard a song by Conway Twitty I have not heard in years. It goes, "It's only make believe." And I was trying to think what he was singing about. He was singing about a relationship with another person, but it could just have easily been dynamic scoring. [Laughter.]

I just want to say, we have been down this road before. We did it in early 1981 with tax cuts for the higher-income people; it did not work. We did it in 2001; we ended up with more debt and, frankly, not the kind of economic growth that we had hoped for.

And the idea of trying it again—there is a saying that says, "third time's a charm." I am not sure the first two times were charmed, and I would have us be careful about going down this road again.

So my question is, Dr. Marron, could you just lay out for our committee what effect a largely debt-financed tax cut would have on long-term economic growth for the U.S. and on our deficits? Thank you.

Dr. MARRON. Sure; my pleasure. Thanks. So if you look at the CBO baseline forecasts of where we are in fiscal terms today, we are on track over the next decade in round numbers to spend around $50 trillion and to bring in tax revenue around $40 trillion, and therefore to have deficits that accumulate over the decade of about $10 trillion. So that will build the debt from around 75 percent of GDP today up to around 90 percent of GDP by the end of the budget window.

That is problematic in its own way. We ought to be on a trajectory where the debt is not rising faster than the economy, right? We want it to flatten out and eventually come down.

If you did deficit-financed tax cuts today, what you would have is—we would have more of that. So you would have, depending on the scenario people have discussed, you would have another $1 trillion, $2 trillion of additional debt over the decade. So adding, say, $12 trillion to the debt over that period.

And the financing of that would have to come from somewhere. And one way it might be financed is by reducing the amount of private investment we see in the United States, and that would, therefore, weaken the amount of growth you would get from a tax reform.

You should always think about these tax reform proposals as being a race between the effects you get from the tax changes you are doing and any effect they have on the budget balance. And if you are increasing deficits over this time period, there is going to be an offset. And in the models I have seen, typically the offset ends up overwhelming eventually, so you end up losing your growth effects.

There are some scenarios in which that does not happen, where foreign capital is very widely available. It comes in and offsets the hit to private investment, but then you are left in a situation where, yes, the U.S. economy is being more productive, but more of the benefits are going overseas rather than staying here. And so either way, there is a cost to debt financing.

Senator CARPER. All right. Let me ask a related question, again of you, Dr. Marron, if I could.

Can you lay out for us what the evidence shows regarding who really bears the cost of corporate tax and your assessment of the assumptions used in models claiming that a rate cut would allegedly help workers?

Dr. MARRON. Certainly. So this is an area that economists have studied a lot in recent decades. I would say the consensus that you see—from CBO and JCT and the Office of Tax Analysis and what my friends at the Tax Policy Center do—is that, clearly, workers pay some of the corporate income tax. The one unfortunate side effect of the corporate income tax is to discourage investment in the United States: workers have less capital to work with, they are less productive, wages are lower.

The mainstream estimates of that are around 20 percent, kind of in the 20- to 25-percent range for the corporate tax system as a whole.

At the Tax Policy Center, my colleagues emphasize that it differs depending on what tax provision you look at. And if you are talking about just provisions focused really directly on investment, you can make an argument that about 50 percent of that is borne by workers. But for the corporate tax system as a whole, kind of the mainstream view is around 20, 25.

Senator CARPER. All right. Let me just say I am all for reducing the corporate tax rate. We are not competitive with the rest of the world. There needs to be a reduction. I hope that as we address that concern, we will keep in mind four questions as we address more broadly comprehensive tax reform.

Number one, the proposal that has come before us, is it fair? Number two, does it foster economic growth or impede it? Number three, does it make the tax code more complex or less complex? And number four, what is the fiscal impact?

We are 6, 7 years into the longest-running economic expansion in the history of our country. And usually at this point in time, I would think we would be interested in addressing the corporate tax problem so we are competitive with the rest of the world, but do so in a way that is fiscally sustainable.

This year's deficit is going to exceed $700 billion, that is 7 years into an economic expansion. The economics I studied as an undergraduate and graduate student said you deficit-spend when you are trying to stimulate the economy, deficit-spend when you are in a recession or something like that, or in a war.

But when you are 6, 7 years into an economic expansion, the idea of somehow doing it all over again and increasing the deficit further, I do not think we should do that. I do not think we should do that.

Thank you so much.

The CHAIRMAN. Thanks, Senator.

Senator Toomey?

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

I just want to follow up briefly on the Senator from Delaware's comments. But let me start with a question.

Is there anybody on the panel who believes that economic growth and output are completely unaffected by all incentives and penalties in the tax code, that they are completely independent and the economy is uninfluenced by good or bad tax policy? Does anybody hold that view?

Okay, nobody holds that view. So does it not follow logically that if you have better incentives and fewer penalties and you have a tax code that creates the right incentives for growth, you have more growth than you would otherwise?

And if we achieve that, then it is not a question of whether or not the economy grows more, it is a legitimate question about how much. And I think we all agree that if we have a bigger economy than we would otherwise have, then there is more economic activity to tax. So the logic behind dynamically scoring tax policy, it seems to me, can only be a question of the extent, but not whether or not we do it.

Now, if you think that the tax reform is actually counterproductive to growth, if you think it is going to create disincentives and penalties for growth, then it should be scored accordingly.

But isn't there a basic—Mr. Hodge, I will throw it to you—is there not a fundamental kind of unavoidable logic that, if you get the incentives right, you will have more growth, and if you have more growth, you can generate more revenue and it is just a question of magnitude?

Mr. HODGE. That is correct. And what we try to tell people about dynamic scoring is that, by and large, most tax cuts do not pay for themselves. But depending on the type of tax cut, it can have macroeconomic effects which will have feedback effects on revenues and will minimize their long-term costs.

Senator TOOMEY. Thank you.

There are a couple of other things I want to get to quickly.

Mr. DeBoer, you seem to be skeptical about the wisdom of allowing full expensing for structures, but that skepticism, I did not hear that applied to other kinds of assets like vehicles, equipment, machinery, other sorts of things. And you acknowledge that expensing of those types of things, non-structures, can be beneficial for economic growth, is that correct?

Mr. DEBOER. Well, I do not necessarily disagree with that. But the facts are, I believe, that under the current law of depreciation and bonus depreciation that is in place, I believe roughly 60 percent of all business investments today are recovered within 18 months.

Senator TOOMEY. Yes; I have very limited time, and I appreciate that.

Mr. DEBOER. And so I am a little skeptical about the bump that you would get from that.

Senator TOOMEY. I appreciate your skepticism. Okay, that was not my question, though. I appreciate that, sir.

Mr. DEBOER. And the Tax Foundation's own study does show that 70 percent of the increase in GDP would come from expensing structures.

Senator TOOMEY. It would be nice if we could move on, sir. Thank you very much.

Mr. Lewis, you had made a point about the accrual method versus the cash method of accounting. Is it true that a fast-growing company that is investing significantly in capital and maybe growing its inventory could be in a position where their tax liability actually exceeds their free cash flow under an accrual system?

Mr. LEWIS. Certainly, they could.

Senator TOOMEY. And so allowing companies to take the cash method has the great virtue of tremendous simplicity, but it also tends to align their cash flow better with their tax obligations. Is that true?

Mr. LEWIS. Yes. Cash method accounting tends to be simpler, like you said, and it does provide a lot of incentive, fewer compliance costs, and they put more money into doing what they do best, which is not accounting, but growing their business.

Senator TOOMEY. Yes. Would you be supportive of raising the threshold that is currently in law that allows for a cash basis for tax purposes?

Mr. LEWIS. Yes. The AICPA has supported Senator Thune's INVEST Act that had a provision in there to increase it, to make it more available to smaller businesses.

Senator TOOMEY. Thanks.

Mr. Hodge, you had mentioned that dollar-for-dollar expensing has more impact on growth than lower marginal rates, maybe than most of the other ideas we have been talking about. Could you briefly explain how that benefit translates to workers? How does that help average workers? How does that help wages?

Mr. HODGE. The key point here is, by lowering the cost of capital, you are improving the opportunities for businesses to invest in tools which make their workers much more productive. Much more productive workers earn more over their lifetimes, and their standard of living rises as a result. So the key here is to incentivize new investment, to increase productivity, which ultimately makes everyone better off in the long run.

Senator TOOMEY. Thanks very much.

Thank you, Mr. Chairman.

Senator ROBERTS [presiding]. Senator Cantwell?

Senator CANTWELL. Mr. Chairman, thank you.

I know my colleagues and the panel have been discussing dynamic scoring and the deficit. So I guess I definitely believe, as we had our last hearing, that dynamic scoring does not definitely lead to dramatic growth. It might, it might not.

And, Mr. DeBoer, one of the things that I am most interested in is, before we launch into this discussion about the tax code, just as any businessperson would do—they take an assessment of the environment and what are the needs and opportunities of that company and what are the needs and opportunities of our Nation.

One of those things that I think has been missing in this equation as it relates to our discussion is, what are those needs and opportunities as it relates to housing? Could you comment on that as it relates to the tax code and what we need to be doing?

Mr. DEBOER. Certainly. I think, you know, most people, most businesspeople who operate certainly in urban areas, recognize that there is a tremendous and growing shortage of what we would call workforce housing. And so people who are middle-American citizens—firemen, teachers, what have you, combined incomes, working very, very hard—are being priced out of our Nation's cities.

And we need to focus on ways to incentivize affordable housing, not just low-income housing, which is obviously needed, but workforce housing as well. And we should not lose sight of that.

I do not have any solutions to share with you, but it is certainly a growing and troubling problem. And as we go forward, that part of our Nation has to be included in whatever is done in economic growth.

Senator CANTWELL. So do you think just cutting the corporate tax rate gets us affordable housing?

Mr. DEBOER. Well no, I do not think it really will have anything to do with affordable housing. It would put, hopefully, more people to work, and it would provide more money in people's paychecks, and perhaps they would have more money to buy workforce housing, but it would not directly stimulate workforce housing.

Senator CANTWELL. Do you think affordable housing is a crisis in America?

Mr. DEBOER. I am not sure I would call it a crisis. I think there is an awful lot of multifamily housing being constructed today, meeting a demand for it, but it is not meeting that segment of the economy. And people need to understand, land is land, and it is going to cost the same thing regardless of its use almost. And construction costs are quite high.

And so when people construct assets—multifamily, retail, office buildings, what have you—they are paying roughly the same cost to construct them. And so it is hard to understand why they would then provide low-income housing or workforce housing, because it does not pencil out for them from an economic point of view. So there does have to be assistance there, we think, whether that is zoning assistance or local tax break assistance or something from the Federal Government.

Senator CANTWELL. Or expansion of the Low-Income Housing Tax Credit?

Mr. DEBOER. Well, keep in mind, as tax reform goes forward and rates lower—and I certainly am not suggesting that we do not want lower rates—but the market for the low-income tax credit is made more robust and more positive because of what rates are. As rates go down, those will become less valuable.

And again, I am not suggesting that rates should not come down. I am simply suggesting that if you keep the low-income housing program as it is, the incentive will naturally be reduced, and perhaps a rethinking of that incentive is in order.

Senator CANTWELL. Well, I think you said something very important there, but I am not sure everybody understood it. Basically, what you said——

Mr. DEBOER. I may not have understood it, but it was fun saying it. [Laughter.]

Senator CANTWELL. I think what you said is technically correct. But the translation is that, basically, because a lot of people who have invested in affordable housing as we have given them incentives for investing in it through the LIHTC program, as they are sitting there waiting to see what is going to happen with the corporate tax rate or tax rates overall, they are sitting on capital and we are actually suppressing the amount of available investment in affordable housing at the same time that we have a crisis.

So to me, as we ponder this big question, particularly as it relates to this issue of dynamic scoring and whether you are going to get dynamic growth from it, I want to make sure everybody clearly understands that housing somehow has lost its way.

It used to be in the 1960s, 1970s, 1980s you would say, when you wanted to stimulate our economy, the cheer would go up for housing, but you have not heard that cheer in a long time. And it is time for us to focus on the fact that affordable housing is a crisis, and it is certainly a crisis in my State; it is certainly a crisis in Seattle. And we need to make sure that we are putting the right incentives in place. This is just as important as the rest of the discussion we are having here.

So thank you, Mr. DeBoer.

Mr. DEBOER. Senator, if I may just add one thing. It was referenced how long we are into the economic recovery—forget about affordable or low-income housing—and home-building in general is off where it typically would be at this point in the recovery anyway. And if it was only where it should normally historically be, our GDP would be a point higher, some suggest. And I just throw that out.

Senator CANTWELL. Thank you.

Mr. DEBOER. And again, those solutions——

Senator CANTWELL. Thank you. No, I call that growth. Thank you.

Thank you, Mr. Chairman.

Senator ROBERTS. I appreciate that.

Senator Scott?

Senator SCOTT. Thank you, Mr. Chairman.

I will make my questions quick, because I have to go vote before we close that vote out.

I was a small business owner for about 15 to 16 years. And I will tell you that the question that seems to be unanswered—I thought Senator Toomey did a very good job of delineating the importance of, from a competitive perspective, how lower rates equal a better competitive position against folks in other countries.

A lower rate also will encourage economic activity in a way that can be scored dynamically. The question is, can we score dynamically accurately? The fact of the matter is, there is no question that the dynamic impact will be measurable, which means that it will be positive.

Another very important factor is the complexity of the code and the amount of time that small business owners spend preparing for the dreaded season of March 15th to August 15th and the times when the extensions run out.

Can you, Mr. Lewis and Mr. Hodge, speak for a few minutes on the compliance costs borne by U.S. small businesses under the current code and what that means long-term for our competitive position and the ability to grow jobs and make future investments?

Mr. HODGE. Well, I can just give you some overviews. We have looked at the overall complexity of the U.S. code and tried to measure it. Americans spend close to 9 billion hours complying with the U.S. tax system. The corporate part of that code is the most complex and the most costly. Things like depreciation schedules among that, as I mentioned earlier in my testimony, cost U.S. businesses about $23 billion a year in compliance costs. This is money that is not only drained from businesses, but it is time taken away from entrepreneurs.

So instead of writing computer code, they are complying with the tax code. This is wasted energy, wasted time, wasted resources that go to, well, complying with the IRS rather than trying to build a business, and that is simply unfair.

Senator SCOTT. Thank you, sir.

Mr. Lewis?

Mr. LEWIS. Thank you for the question. The AICPA has 12 guiding principles that we believe should be considered as part of any tax reform discussion. There are many of them, but you hit on a couple of them that I think are important. The first one is equity and fairness on the one side. On the other side is simplicity.

The thing about it is, often one principle in these 12 guiding principles has to be compromised at the expense of another to achieve the common objective. So it is that tradeoff that you all are debating now where the rubber hits the road. Reconciling the competing interests of each of the guiding principles can be difficult.

You know, the thing about it is, the code will probably never be simple, but, man, it sure could be a lot less complex. And so anything that you can do along those lines to make it less complex would benefit all businesses in our country.

Senator SCOTT. Thank you, sir.

Thank you, Mr. Chairman.

Senator ROBERTS. Unlike Shane in the movie sometime back—I realize that two-thirds of the audience do not even know what I am talking about—but at least Shane never came back, but Chairman Hatch will come back. [Laughter.]

I remember 1986, the last time we did tax reform. We have pictures of the gentlemen who were in charge: Senator Packwood, Senator Dole, others. When I reviewed the tax proposal at that particular time, farmers in my district—I was then a member of the House—said they were going to take a pretty big hit. Real estate also said, listen, this is really not what we think is appropriate.

And then the S&L business was very worried, rightly so—they went out of business. One of my very best friends went broke who had a cow/calf operation.

So I listened to those people, and I voted "no." I was the only one in a several-State area who did that. I think the most important thing that happened in that regard was that Bob Dole did not speak to me for 6 months. That was not all bad, but that was probably a very good relationship. [Laughter.]

I have a theory. We are all wrapped around the axle with regards to offsets and revenue, so on and so forth. You all have been talking about expensing, depreciation, State and local taxes. You have not mentioned—I am surprised you have not—the deduction of interest for various things, your health insurance, so on and so forth.

When you do that, I have a red ant theory. Every time you touch something that is in the tax code, it has been there on purpose even though it is 9 feet tall, and we have to do something. But I would prefer to see us do the big things, not worry so much about the dynamic scoring—although that is a big issue for many—just for my personal preference.

Lower the corporate rate, we have to do that, the business rate, but I would prefer we call it a business rate. And then also go from 7 to 3 on the brackets, same with the middle class.

I would fix AMT. I would do something with the estate tax. There is one more that I am missing. Oh, repatriation; but obviously, if you lower that rate, why, that supposedly takes care of that. And call it good and not go into all these other details.

I know some members in the House do not buy that argument at all, but it sure would save us a lot of time. And all these other things that I have mentioned—you have various interest groups coming in, and it is the red ant theory, based on an experience when a Senator from Kansas tried to give a speech when he was standing on a hill of red ants. That did not work out very well. They crawl up your leg and bite you pretty good.

How do you feel about that, more especially with the 1986 example? Does anybody want to take that on?

And the chairman is back, and I will yield to him, but I will listen. But not for very long, because I have to go vote.

Mr. HODGE. Very quickly.

Senator ROBERTS. Very quickly.

Mr. HODGE. The 1986 act has gotten a lot of mythology over the years. We actually went back and modeled the economic effects of the 1986 act. We found that it actually raised the cost of capital, mainly by shifting the tax burden onto businesses at the expense of giving tax cuts to individuals. As a consequence, we found it had the effect of actually slowing economic growth, not boosting growth.

Senator ROBERTS. Well, and 4 years later our friends across the aisle simply raised taxes, and there was a lot of blood on the ground. And I do not see the need for doing that again, so I hope we can stick to the big items.

And I note that the distinguished chairman is back. Thank you.

The CHAIRMAN. Thanks, Senator.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman.

I thank all the witnesses.

Mr. DeBoer, I am sorry I was not here when you were talking about incentives for energy efficiency. We are strongly going to work to make sure we can preserve those issues.

I want to ask a question about the pass-throughs, as to what is a fair way to handle this. Pass-through companies do not have to pay double taxation, that is true; however, when you look at global competition, they are still paying a much higher rate than their global competitors because of the marginal tax rates in the United States. And the overwhelming majority of American businesses do not pay the C rate. I think the C rate now amounts to about 5 percent of the companies, somewhere in that level.

So as we look for reform in order to make our business tax structure more competitive, if that is one of our goals for growth, what do we do about making sure we do not have the unintended consequences of hurting those companies that have the current status as pass-throughs? How do we protect them if the rates do not change, if we just do the C rate? How do you deal with that issue?

Mr. DEBOER. Senator Cardin, I will take the first swing at that. And we do appreciate your work on energy efficiency for buildings. It is a very, very important topic going forward, and hopefully it can be included.

Pass-throughs—certainly for our industry, very, very few real estate businesses are operated in corporate format. Almost all are LLCs, publicly traded or privately traded REITs, or partnerships. In fact, real estate consists of almost half of all partnerships in America, so we are highly concerned and focused on how we can achieve a lower tax rate for those entities.

Right now, there is a 5-percent spread between the corporate and the ordinary rate. We see no reason that if the corporate rate is coming down that a comparable spread should not be the result of tax reform this time, or you are going to put pass-through entities, which really drive the economy in many ways in the United States, at a disadvantage, not only globally, but vis-à-vis their competitors in the corporate world here. So we want to work on that very, very much.

Senator CARDIN. I agree with that.

Mr. DEBOER. And I mentioned to Senator Wyden, Senator, that we share the concern about potential shifting of what is service-related income in a pass-through into that lower bucket. And we have worked very, very hard internally to try to come up with a way to deal with that.

Senator CARDIN. Well, I thank you for that response. I think we all have to keep our eyes on this issue, because it could get lost in some of the proposals that are being made. And I agree with the point that you made: particularly in the real estate sector, the pass-throughs are critically important. I know they are in my State.

I know that Senator Carper talked about being fiscally responsible. One of the worst things we could do is add to the deficit in deficit-financed tax reform, because that will be an anchor on our economic growth. And I know he talked about how we score, and I hope we will use the Joint Tax traditional scoring.

But I also raise another issue, that one of the proposals that has been out there is talking about timing and the Rothification of the 401(k)s. That scores as a revenue gainer, even though over the long term it is neutral.

And I think we are just going to have to be very careful, Mr. Chairman, as we look at these issues. There is also, of course, the retirement security issue, which is very important, to make sure that we not only maintain, but strengthen those needs.

I want to get to the fundamental point, and that is, if you really want to deal with competitive rates, if that is your issue on the business side of tax reform, I think it is impossible to do unless you bring different revenues into the equation. Every industrial nation in the world except the United States uses consumption revenues in addition to income revenues. We are the only country that does not.

How do we expect to have competitive business rates if we do not harmonize with the international community as to the source of our revenues? So I have introduced a progressive consumption tax, because one of my major objectives is to make sure that the new tax code is at least as progressive as the current code as it relates to middle-income families, and there is a way of doing it. But how do you get to competitive rates globally with industrial nations if we continue to be stubborn and use only income revenues to the exclusion of consumption revenues when the rest of the world is doing that?

Dr. MARRON. So I think you are left with a lot of bad choices, right? So you could run much bigger deficits as a way to get the rate down, but that is not going to be good in the long run.

You know, I end up mentally in the same place where you are, which is, if you want to get down to rates below the high 20s, if you want to get lower on that rate, you are going to need to go shopping for a new revenue source. The destination-based cash flow tax is a species of consumption tax that has some of those attributes, can bring in some more revenue, but it seems to have gone by the wayside.

There are still more traditional value-added taxes you could do. I personally am a fan of the idea of a carbon tax which could provide significant revenue, encourage clean energy, and help combat pollution. It would be one strategy.

And then of course, another strategy is also to look to shareholders. If you are reducing corporate taxes, you should keep in mind that some of the beneficiaries are going to be taxable shareholders. And it is perfectly reasonable to look to them to think about ways of increasing taxes on shareholders to partly offset or fully offset the gain that they get.

Mr. HODGE. And, Mr. Cardin, I will give you credit for the progressive tax reform that you have put forward. We modeled your plan and found it to be exceptionally pro-growth, and not only, I think, pro-growth, but I think it was revenue-positive. So it is possible. And you used an offset of a value-added tax to lower the corporate tax rate to, I believe, 17 percent, and that had a pretty powerful effect on boosting economic growth with that lower corporate rate.

Senator CARDIN. Yes, I appreciate that. My objective is that, since America, among industrial nations, is near the bottom on the percentage of our economy and government, we should have a competitive advantage, not disadvantage on our business taxes.

The CHAIRMAN. Senator Brown?

Senator BROWN. Thank you, Mr. Chairman. Thank you to all four witnesses; good to see all of you.

My question is for Dr. Marron.

We have heard a lot of talk about what is good for large U.S. companies. We have heard, frankly, far too much talk about what is good for corporations and not enough talk about what is best for American workers. And it is American workers who have been hurt most by our tax policy and our trade policy in the last 20 years. We need to encourage companies to invest in their greatest asset, the American worker. We do it with a carrot and a stick.

This month, along with Senator Durbin, I introduced the Patriot Employer Tax Credit Act. It simply says that businesses that pay good wages of $15 an hour and provide benefits and do not outsource their jobs and buy American, basically, that those companies would get a tax cut. Conversely, when corporations pay poverty-level wages, someone has to pick up the tab. It is American taxpayers. Food stamps, housing vouchers, paying for Medicaid, paying the Earned Income Tax Credit—taxpayers pick that up.

So if you are a huge corporation under our proposal and you choose to pay your workers so little that they are disproportionately forced onto government assistance, you need to reimburse American taxpayers. That is our corporate freeloader act.

The debate over tax reform is a chance for us to reconsider how we have been told to think about this economy. You do not build the economy by doing a tax cut for corporations and hope it trickles down. We know from comparing the 1990s to the next decade, that simply does not work. You build the economy by investing in the middle class and build the economy outward.

So, Dr. Marron, offer suggestions, if you will, for other ways we safeguard against corporate tax reform that overwhelmingly helps corporate America at the expense of American workers.

Dr. MARRON. Sure. So, you know, I think you want to look at it through the lens of, if you are doing business tax reforms and tax cuts, do they encourage more investment here? Because that is the one channel that will have significant benefit for workers. And you want to de-emphasize the cuts that are just going to accrue to shareholders and not provide that sort of competitive advantage.

I think the other thing is, you want to think about other aspects beyond the business tax code. You know, there has been a lot of discussion about worker credits, about expanding the EITC, the Earned Income Tax Credit, things like that that could provide support and encouragement to a broader array of workers, boost their take-home pay, make them more attractive to employers. And I think that is very worthy to consider as part of an overall tax reform package.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Heller?

Senator HELLER. Mr. Chairman, thank you. Thanks for holding this hearing, and thanks to the ranking member also. And for those on the panel, thank you very much for taking time and being with us today.

For too long, Nevadans and America's small-business companies have been at a competitive disadvantage due to our outdated and unfair tax code. A Nevada business owner recently told me that our tax system makes it difficult for him to compete. Another Nevadan wrote me and said that we need to fix our tax code in order to attract businesses to our country, drive up wages for American workers.

Our current tax code distorts the marketplace, drags down the economy, prevents American job-creators from staying and hiring at home. Just last month, I hosted Treasury Secretary Mnuchin at a tax reform roundtable in my home State of Nevada. There we met with some of the silver State's top job-creators. And time and time again we heard the same thing: Nevada needs lower tax rates on its businesses.

Lower rates mean a faster-growing economy, increased international competitiveness. Lower rates will also mean more jobs, better jobs, and higher wages, all of which the middle class desperately needs right now.

Just last week, it was announced that Nevada leads the Nation in private-sector job growth at 3.6 percent. And imagine what our State, and for that matter the country, could do if we at least delivered on tax relief.

So after 8 years of historically low growth under the previous administration, it is time to get our economy back on track, help our workers and small businesses win on the international playing field. So I look forward to working with all my colleagues here as we move forward on business tax reform and individual tax relief.

I want to speak really briefly here on the corporate tax rate and its impact on labor. Mr. Hodge, I missed your opening testimony, but I assume you talked a little bit about this. The empirical evidence suggests that workers bear a sizable percentage, at least 45 percent, of the corporate tax burden. Is that an accurate comment?

Mr. HODGE. Yes. In fact, we have a paper coming out in the next week or so surveying the economic literature. And it shows that a substantial portion of the corporate tax does fall on workers in some fashion, roughly about half. And in some cases, it can be as much as 100 percent.

For instance, if the factory that I work for moves from Dublin, OH to Dublin, Ireland to take advantage of the Irish 12½-percent corporate tax rate, I have borne 100 percent of that differential between the Irish rate and the United States rate. So corporate taxation can have an overwhelming influence on hiring and wages. And the economic literature shows that pretty clearly.

Senator HELLER. I have a table here that comes from your organization. And a quote on it shows that a 20-percent corporate tax rate would lift after-tax incomes by an average of 3.5 percent. Do you stand behind that?

Mr. HODGE. Yes. Our model shows that, and it is because the combination of the economic growth and the increase in productivity will ultimately lift both wages and after-tax income.

Senator HELLER. Your model also estimates that the combination of a 20-percent corporate tax rate and full expensing would boost after-tax income by an average of 5.2 percent. Do you still stand behind that?

Mr. HODGE. Yes, absolutely.

Senator HELLER. Can you expand on any of this information? And what we are trying to do is get to individual tax relief. How can we boost an individual's income, take-home income, by perhaps a tax policy that works for all Americans? And starting here with these numbers that you show in this model.

Mr. HODGE. Well, tax relief for individuals is important, but if you have not had a raise in more than a decade, a tax cut does not really benefit you. What we want to do is have policies that lift wages, lift productivity, and ultimately lift after-tax incomes, real living standards. And the kind of tax reform that we have outlined here, with the lower corporate tax rate and full expensing, will do that. And I think that that is the strongest approach to making people better off.

Senator HELLER. What would the average household prefer, a tax cut or a raise in income?

Mr. HODGE. Well, I think, you know, most people want a tax cut. They do not really see the connection between corporate tax reform and the improvement in their daily lives. And we need to convince them that, ultimately, corporate tax reform will boost their standard of living in the long term. It is just a hard sell.

Senator HELLER. Yes. Mr. Hodges, thank you.

Mr. Chairman, thank you for my time.

The CHAIRMAN. Thank you, Senator.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. And I want to thank each of our witnesses for being here this morning.

I think we have a historic opportunity with tax reform to reform our antiquated tax code and to address the concerns that I continually hear from South Dakotans on jobs and our economy.

And last week, we had the opportunity to focus on individual aspects of tax reform and the importance of making sure it provides tax relief for middle-income taxpayers. And today we have an opportunity to look at the business aspect of tax reform, which is a critical component of this effort as well.

There is significant overlap, I think, however, between the two hearings. Because if we can streamline and modernize our outdated tax code on the business side, it will enable corporations and pass-through businesses, both small and large, to reinvest, expand, create new jobs, and increase wages. And that means real benefits for middle-income families in South Dakota and across the country through the businesses that employ them and for many through the small businesses, farms, and ranches that they also own.

This is a strong panel. I want to get into the questions here if I can.

I will begin with you, Mr. Hodge. In your testimony, you make an important point when you note that corporate tax reform may not put cash in people's pockets in the same way as cuts in the individual rate, but that it can have a powerful effect on lifting after-tax incomes and living standards. And I am just wondering maybe if you could elaborate on that connection between business tax reform and tax relief for middle-class workers and families, especially if we assume that a reduction in the corporate tax rate would be accompanied by reductions in the individual tax rates that affect working individuals in this country.

Mr. HODGE. When economists at the OECD studied which taxes were most harmful for growth, they found that the corporate income tax is the most harmful tax for economic growth, and in large measure because capital is the most mobile factor in the economy. So when we lower the tax on capital, we find that the economy becomes much more productive, people have better tools to work with, and their standards of living rise. And that ought to be the primary goal of tax reform, to lift people's real standard of living.

And you can try to do it through just cutting their income taxes, but I think the right kind of business tax reform does the most to lift people's after-tax incomes and ultimately their standard of living.

Senator THUNE. Yes, thank you.

Mr. DeBoer, in your testimony you make the case against the immediate expensing of real estate, given the unique nature of these assets. Your testimony also notes the recent MIT study that suggests the recovery periods for commercial real estate under the current tax code are out of sync with the economic recovery period of such property.

Since we are trying to build a tax code that will promote sustained economic growth, would shortening the recovery period for commercial buildings from 39 years and rental housing from 27½ years be a reasonable alternative to immediate expensing?

Mr. DEBOER. Yes. We strongly believe that. And I do not disagree at all with what has been said about the power of expensing. I am simply saying that sustainability in our industry—it will incent our industry to build, but we see no benefit to building buildings that are ahead of the demand in the economy. It puts stress on local markets. It puts stress on lenders' balance sheets. And ultimately, it is not good for the long-term growth of the economy.

And so we are, from our industry, more interested in economic lives of assets and real estate. As MIT has studied, real estate's proper economic life is closer to 20 years than 39 or 27½ years.

And by the way, there is some misunderstanding about real estate. Why would you depreciate a building that people see standing for many, many years? And these buildings are very, very capital-intensive. It is not just that they fall down. People invest money into these buildings to keep them a competitive part of our economy and allow these buildings to adapt and be flexible to accommodate business as it changes over time.

And I do not think anyone here would want to move into an apartment or work in an office that has not been rehabbed and updated for 30 or 40 years. So that is what this depreciation is about. It is both physical wear and tear and economic obsolescence. So yes, I agree with what you are saying.

Senator THUNE. And you suggest, I think, a 20-year recovery period. Would you apply that to both residential and nonresidential property?

Mr. DEBOER. I would, but there might be an argument based on what Senator Cantwell suggested earlier, that you may want to have a different life for residential versus nonresidential, which is in current law today. And that is there largely as an incentive for housing.

Senator THUNE. And lastly, should we consider expanding the 15-year recovery period that applies to improvements to certain type of real property and/or shorten that period as well?

Mr. DEBOER. Well, if tax reform adopts an expensing policy for all assets other than longer-lived—and that is how I would define it, a longer-lived asset like a structure—then I would say that lease-hold improvements to accommodate the business needs should be expensed like any other business investment, if that is the direction that Congress goes.

Senator THUNE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Wyden?

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

Let me start with you, Dr. Marron. As you know, there has been a lot of discussion about the President's proposal to create a special pass-through business income rate, which strikes me as a giant tax giveaway for the top 1 percent, masquerading under the guise of helping small businesses.

I was trying to look through your various charts. We have a history in this committee of doing a lot of charts. In your view, how much of the benefit goes to the top 1 percent in the special pass-through?

Dr. MARRON. I do not have the chart right in front of me, but the result, as you say, was that if you do a maximum rate like that, by definition all the benefit has to go to folks of qualifying income who would be in a higher tax bracket. And so the overwhelming majority of it goes to people in the top 20 percent and a very large portion goes to people in the top 1 percent.

Senator WYDEN. Okay. Now, the administration has said—although it has been months since they said they were going to get this corrected. I asked Secretary Mnuchin, who sat where you all are, about this. They have never done anything to correct it. I just would be curious what you think of this argument that there are ways to ensure unscrupulous individuals are not going to turn this particular tax break into a massive loophole.

Dr. MARRON. So it is a race. If you create a very large tax benefit to being able to declare your income in a certain favored form, you are going to create a lot of people all along the scrupulousness dimension—I am a scrupulous guy, but I would LLC myself if it were legal and gave the right incentives and did not remove my political viability—all the way to people who will, you know, bend the rules and break the rules.

If you are talking about a tax gap that is 30-something for ordinary income and 15 for pass-throughs, that is a giant incentive for people to try to figure out how to get around it.

The IRS, legislators, will write some rules to try to limit that. But my view of this is always that you should view it as an ongoing iterative game, and the folks out there in the business world who are looking for ways to get the lower rate are going to keep working on that, keep working on that, and over time you are going to have more of a problem.

Senator WYDEN. Well, you are right. And of course, they have vast arrays of talent to help them find those kinds of holes. And I think your point is especially important.

Mr. Hodge, let us talk a little bit about some of the history on retroactive and temporary tax cuts. You all have done a lot of research on this. We have talked to you often on our bills. In 2001 and 2003, there were the Bush tax cuts. The advocates said, well, this is going to be a panacea of economic growth, and what we saw was really a mountain of debt and a windfall for the affluent.

Now, there are some in Congress who want to bring back temporary debt-financed tax cuts, and they are making pretty much the same kind of grandiose promises. And my sense is, and you all have done a lot of work on this, that we have seen this movie before. You all have done a lot on this topic lately, demonstrating what I think really ought to be called the sugar-high effect, where you get a small bump in the short term followed by a longer period of lagging economic growth.

So if you would, tell me in your view, based on the work that you all are doing there, what happens when you go after another temporary tax cut? And I think your research shows most of the temporary tax cut goes to the corporate shareholders, people who are well-off. So why don't you give us your thoughts on that.

Mr. HODGE. Sure; a temporary tax cut can be sort of the tax equivalent of cash for clunkers, where it can draw activity from the future to the present, and then ultimately future activity declines below baseline.

We analyzed lowering the corporate tax rate for a short period of time, say even a 10-year window, and we found that it did have a boost in economic growth in the short term, but since it pulled activity from the future, long-term economic activity declined below baseline. So it ultimately slowed growth at the expense of having growth in the near term.

Senator WYDEN. And your colleagues do seem to suggest that most of the benefit from these temporary cuts goes to the corporate shareholders, a disproportionate number of whom are wealthy.

Mr. HODGE. Yes, in part because, again, you are pulling activity forward that can have a temporary boost in corporate profits, and that, in the short term, will flow to shareholders and owners of capital rather than workers.

Senator WYDEN. I want to continue this discussion, because it seems to me retroactive, debt-financed tax cuts, particularly temporary ones, are a prescription for more trouble in the American economy in the long term. And that is why over the years what I have tried to do, most recently with a member of the President's Cabinet, then-Senator Coats, who sat over there, was to try to break that kind of cycle. So I appreciate the scholarship and your answers.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Warner?

Senator WARNER. Thank you, Mr. Chairman. And I appreciate the panel.

I want to go back to the chairman's opening comments where he, I think, acknowledged, and I will acknowledge as well, that the United States corporate rates are some of the highest in the world. Now, our effective rates are not as high.

But I guess I would like for the whole panel to comment, if there is any disagreement in at least the factual basis that I work on, that while America has statutorily the second-highest rate, all of our competitive countries that we compete against, all who have substantially lower corporate rates, all have a different revenue source structure than we do.

When we look at, particularly, some of our European competitors that have dramatically cut rates and continue to cut rates, the way they make up for that is they have a VAT or a GST. And when you actually compare, within that same kind of corporate comparison, apples to apples and you look at where America ranks in terms of its total tax burden—State, local, and Federal, as a percent of our GDP—we actually rank 31st out of 34.

So remarkably, the countries that have much lower corporate rates have actually raised a much greater share of their GDP in taxes, have a much higher tax burden.

Does anyone want to counter or contradict that? I mean, I do not want to go down the whole list here, but I would think it is important when we are thinking about how we lower corporate rates, which I think makes sense, that you have to pay for it.

And one of the things I am going to start with, Dr. Marron—I mean, I see today, because we are not part of this process yet, in *The Wall Street Journal* that the majority is talking about a $1.5-trillion tax cut. The question I have when you are talking about a $1.5-trillion tax cut in a country that already has $20 trillion in debt, accumulated debt created by both parties for a long time, when you also have, based upon some of the growth assumptions—the administration has been using a 3-percent growth rate while CBO has a 1.8-percent growth rate—the delta on just the growth rate differential creates an additional $3 trillion of potentially fictional revenue.

If you have $3 trillion of fictional revenue there and you have $1.5 trillion of unpaid tax cuts, adding that $4.5 trillion at a minimum of additional deficit-financed tax cuts, Dr. Marron, what effect do you think that would have on the economy?

Dr. MARRON. Right. So as you know, if you look at CBO's forecast, we are on track to add about $10 trillion to the debt over the next 10 years. So, adding another trillion, trillion-and-a-half would obviously make that even a more severe challenge. Debt is rising faster than the economy at the moment. Despite the fact that we are well into an economic recovery, the unemployment rate is just below 5 percent. In normal times, this would be a period in which you would think about bringing deficits down, strengthening the fiscal balance sheet so that we will be well-positioned for challenges that come in the future.

If you expanded deficits now with an unfinanced tax cut or only partly financed tax cut, you have the traditional problem that the money has to come from somewhere. The resources—it is really about the resources underlying that, right? The resources would have to come from somewhere. It would either crowd out private investment, or if it attracted a lot of overseas investment, what it would mean is that more of the economic output in the United States in the future would go to foreigners rather than Americans.

And so either way you slice that, you end up in a situation where there is a significant economic drag from substantial increase in deficits.

Senator WARNER. And I guess what I would point out again to the majority is, back in 2013 when we thought about starting this exercise again, my Republican colleagues started with a unified letter saying that tax reform needs to be revenue-neutral. And it is curious to me now, even before we get to dynamic scoring, that we are talking about different growth assumptions and somehow baking into a budget resolution the allowance for $1.5 trillion of unpaid tax cuts, the growth assumption numbers you add on some of the scoring issues.

And when you think about one of the concerns I have—and I am not going to get to my other question—the challenge we have, as well as the aggregate amount of debt that has been created is, even if this was starting with a clean balance sheet, it would be problematic. But it is exponentially more problematic when you think about an era when I think most economists assume we are going to see a rising level of interest rates.

So debt service payments alone will squeeze out our country's ability to make any other kind of significant investments. We will have entitlement programs and an Army and not much else.

Comments?

Dr. MARRON. Yes, so we have been fortunate in that the dramatic increase in debt we have seen in the last decade or so has been accompanied by incredibly low interest rates. And so the immediate interest burden is relatively small or normal by historical standards.

But if, as CBO anticipates, interest rates go back up to what we think of as a somewhat more normal level, right, you would see a dramatic increase over time as our debt rolls over and interest payments roll up.

Senator WARNER. And one last comment, since my time is up. But isn't it, I mean, roughly—and again, if anybody would counter this, I would be happy. But for every hundred-basis-point increase in interest rates, with the accumulated debt we have now, and not even talking about some of these additionals, are we not talking roughly $150 billion to $160 billion a year of additional debt service per hundred-basis-point increase in interest rates, roughly?

Dr. MARRON. Yes, roughly, once it rolls over. Right. So we have $15 trillion in outstanding publicly held debt, right? Multiply that by 1 percent, and you get $150 billion a year, yes.

The CHAIRMAN. Senator McCaskill?

Senator MCCASKILL. Thank you, Mr. Chairman.

Although pass-through businesses represent 95 percent of the businesses, the income is not so evenly distributed among the business owners. More than half of all pass-through income in the United States goes to the top 1 percent of all taxpayers. So the data would suggest that a simple rate cut for pass-throughs is a huge tax cut to the 1 percent; there is no question about that. It seems like this would just be an opportunity for more loopholes.

You know, Dr. Marron, your testimony warned us that the changes to the pass-through rates could create incentives for gaming the tax system. Could you speak to that? And I appreciated the fact that Senator Warner mentioned that we are the only developed nation that has no kind of consumption tax. We are it. We are the only one. So if we are going to follow them down the path of a lower rate, not just for corporate, but also for pass-through, we are asking for a real hit on prosperity in this country in terms of debt. And I would like you to speak to that, Dr. Marron.

And I particularly would like you to speak to—I remember the days when Kansas was going to be a mecca for job creation. They did this massive tax cut, and it was going to rain prosperity and wage increases. Could you explain how things went so awry in Kansas because of the pressures they felt in terms of funding public education and all the other needs they had in Kansas? And frankly, it has been an unmitigated disaster in Kansas.

Dr. MARRON. Right, so thank you. I guess I will do first first. So as you describe, if we go down the path of creating a new special pass-through business income tax rate that is lower than ordinary rates, just by construction that is systematically going to go to high-income folks, both because the business income is concentrated at the high end and because that maximum rate is, by definition, only going to help those people who are in higher tax brackets.

And so mechanically, it is going to have exactly that effect of focusing on the high end. And it creates this loophole concern that people are going to restructure their activities to qualify for that lower rate. What we saw in Kansas——

Senator MCCASKILL. So when you say restructure their activities to move to pass-through entities, that is why we have seen explosive growth in pass-throughs in the last decade.

Dr. MARRON. Absolutely. And there are a lot of good things about pass-throughs; I have nothing against pass-throughs. The challenge is, you do not want the tax code to over-reward them.

Senator MCCASKILL. Right.

Dr. MARRON. The situation we saw in Kansas was so extreme that a lot of otherwise ordinary, normal people, high-income but otherwise normal people, would go out and restructure their activity solely to qualify for that, not to create any new economic activity. And so the net effect was, the State had less revenue and there was no benefit from that.

And so what we have seen is, of course, the State is now walking back from that, because that is just a nonsensical approach to taxing and taxing pass-throughs at the State level.

The larger point that both you and Senator Warner raised is about how our tax system compares to the rest of the world. Now, we do have States that have retail sales taxes, so we do a little layer of consumption tax spread across the States. But we are, as you described, very different from the rest of the world.

The rest of the developed world has significant consumption taxes, value-added taxes. It is a tax rate you know how to administer; it is a very efficient way to raise revenue.

People worry that those taxes are regressive. But the way the rest of the world deals with that is, they have substantial value-added taxes and then they spend some of the money in such a way that it offsets the regressivity.

Senator MCCASKILL. Let us talk about complexity for a minute. How much—and any of you can address this—but how much more prosperity would we have, how much more economic activity would we have, if we could just agree on how to define a child and how to define a small business in the tax code?

You know, it is unbelievable how complicated it is for small businesses, because there is not a consistency within the code in terms of what a small business actually is. I cannot imagine the productivity that is lost in terms of tax decisions that are being made just because of that added layer of complexity.

Mr. LEWIS. So, Senator, that is a great question. As I mentioned just a moment ago, the tax code will probably never be simple. We live in a complicated world. But it surely should be a lot less complex.

The message that you just sent about how we define a child or how we do some of these other things, I think you have to look back historically how we got there. We have a situation where well-meaning legislators over time, for one reason or another, put something in, and we simply never take anything out. So the question is, how do we end up with so many retirement plans? That is confusing to the average American taxpayer.

So I think that is why this opportunity today for tax reform is so wonderful. I mean, we are 31 years next month since the last time we did this. This is a time to look at it and clean it up, because American taxpayers need more time to worry about running their businesses and less time about how to comply with the code.

Senator MCCASKILL. Do you think that it is realistic that Congress can do that part of it well in 60 days?

Mr. LEWIS. Well——

Senator MCCASKILL. Come on, you know, let us tell the truth here. Can we actually provide permanency, stability, predictability, and less complexity out of this congressional body in 60 days?

Mr. LEWIS. I will say this. I will say that the effort for tax reform has been happening for a long time. I hearken back to Chairman Camp's H.R. 1 in 2014. There has been a lot of work that has gone into that effort and has got us to this point. Whether or not you are close enough to the finish line, I think that is something that you will have to decide. But in terms of effort, you know, 3 or 4 years of constant talking and going back and forth, I know is welcome relief for taxpayers. And I wish you well in that process.

Senator MCCASKILL. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

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

First, let me say that I support tax reform that puts money in the pockets of hardworking people in Michigan and across the country. And I want to make sure that the tax code incentivizes American jobs.

And, when we look at what we need to be doing, it is also important that we are critically analyzing subsidies that do not make any sense anymore. And at the top of the list for me are the subsidies provided to the top five big oil companies through the tax code. Those may have made sense 100 years ago when they were created; they make absolutely no sense now.

In many cases, these tax breaks are really ridiculous, saying that oil companies are treated as manufacturers for purposes of the domestic manufacturing deduction, for example. Oil companies have enjoyed billions of dollars in special tax breaks totaling $470 billion. And while receiving those tax benefits, they have enormous profits. To keep the tax incentives, they then turn around, the top five companies, and spend a lot of money on lobbying to do that. And I am sure that they are doing that right now.

So my question is, and, Dr. Marron, I would say to you, does the evidence show that these oil company subsidies provide benefits to consumers that would warrant keeping them in place as we do tax reform?

Dr. MARRON. I will say I have not seen any evidence that would suggest that.

Senator STABENOW. Thank you. What should we be doing when we are talking about effective ways to target tax dollars to create American jobs and put more money back in the pockets of the majority of Americans?

Dr. MARRON. So on the business side, I think the key thing is that you want to encourage investment in the United States and you want to encourage the kind of investment that has the most benefits. So things like research and development can have spillover benefits to the rest of the economy, and you would like to encourage that.

You know, basically, capital accumulation, equipment and whatnot, in the United States makes workers more productive. And over time—I know we have had issues with this in recent years—but over time the evidence is still very strong that if workers have more and better capital to work with, that eventually shows up in their wages, salaries, and benefits.

Senator STABENOW. Well, my concern is, as we are debating right now, various proposals we have seen would actually do away with manufacturing incentives, cut interest deductibility, maybe cut cost recovery and use the money simply to reduce rates, and that is one of the big debates right now.

And my concern is, that means you are incentivizing a new advanced manufacturing facility in Michigan the same way you would be if it was in Mumbai, or incentivizing an American job the same way that you would be incentivizing a job being created in China.

And I think that is a big problem as we are having this debate right now. And so how would reducing the tax incentives that encourage companies to invest here impact their decision as to whether they would invest and create jobs in the United States?

Dr. MARRON. This goes a little bit back to Senator Roberts's discussion. I do not know if you all were here when he talked about the red ant problem. So there are a lot of moving parts that affect business decisions about where to invest and how to invest. And the challenge for you—and this is why I said in my opening remarks that I feel your pain, because it is very hard to balance all of those. The rate matters, the treatment of depreciation and expensing matters, the treatment of interest deductibility matters, and the things focused on particular industries like manufacturing all matter.

And the challenge is, how do you put together a package of those that puts us on a trajectory of more growth? And I think the answer is that there are good arguments for bringing the top rate down, because it is so out of line with the rest of the world. There are good arguments for making some amount of depreciation even more favorable and treating investment in the U.S. more favorably. But then you are left with a situation of, how do you pay for that?

Limiting interest deductibility is the first thing that comes to mind. And then we get into the discussion we were having previously about other potential revenue sources.

Senator STABENOW. But when we are looking at things like cutting interest deductibility, we are actually seeing the possibility of raising taxes on small business and others that are actually growing and creating jobs in our country.

Dr. MARRON. Yes. And so one of the big challenges is that there are some portions of our economy, particularly small business, where we have already given them expensing. So they already have full expensing for their investments, and so a tax reform proposal that would move toward expensing but limit interest deductibility will not help them. So we are kind of—this is one of the corners you find yourself painted into, that while a move towards expensing and limited interest deductibility could be attractive for many larger businesses and could encourage more investment in the United States, it does not do anything for the small businesses that already get to take advantage of expensing.

Senator STABENOW. Thank you.

Mr. Chairman, I hope we can come together and do something that actually does more than a trickle-down tax cut for the top 1 percent and that would tackle the subsidies that do not make sense in the tax code and reinvest those in the incentives that are going to create jobs in America. Thank you.

The CHAIRMAN. Well, thank you, Senator.

This has been a particularly good panel. I have really enjoyed each and every one of you and your comments.

And I have heard from my colleagues across the aisle the parade of horribles that will ensue if Congress enacts a proposal to provide a lower business income tax rate for pass-through entities: that it will only benefit the rich and that it will, according to Dr. Marron, quote, "inspire tax avoidance," which it may do.

And yet, two of you today have come to the table with what I consider to be thoughtful approaches on how to address the concerns that compensation or wage income that is taxed at ordinary income tax rates will be inappropriately recharacterized as business income subject to a preferential business income tax rate.

I would like to have Mr. Lewis and then Mr. DeBoer comment on their proposals, whether the concerns raised are legitimate, but perhaps overblown, and provide us with their thoughts on administrative issues associated with their proposals, if they would.

Mr. LEWIS. Okay. So thank you for the question, Senator. First of all, our laws should encourage and not discourage the formation of pass-through entities. The reality, and I think the panel has indicated this today, is that so much of our business is conducted through pass-through form in this country. And we are competing globally with companies that are structured in different ways.

One thing to keep in mind is that a pass-through entity has the same kind of demands that a C corporation has. They have to have the investment in tangible and intangible property, real estate, technology, intellectual property, and, most importantly, human capital. All businesses have uncertainty and risk, and there should be a consistency and fair treatment of all.

So now to your point about the gamesmanship and the potential here. There are a lot of different issues that entrepreneurs consider when they make the decision as to what entity to form. Income tax is important, and I do not want to diminish that, but the reality is, as I have worked with individuals, that is only one of about a dozen. They also consider implications of losing one's tax benefits, like fringe benefits, losing unemployment coverage, covering one's own health insurance now because they have gone out to form their own business, and then also the costs of managing a business: malpractice insurance, training, technology, software. This is not just a flip-the-switch and walk-across-the-street-type proposal.

So that is why we have proposed an anti-abuse-type regime, because I think you are right. And the proposal we have come up with is, for once, codifying the reasonable compensation standard that is now just administered through the courts.

And then we should go further, as some of the proposals do—H.R. 1 from Chairman Camp, for instance—and come up with some sort of, I think some have called it a rough justice, but a split between earnings as an employee versus earnings from investment, and make that a safe harbor so that it is more administrable.

So I think what you want to focus on is to create some sort of a rule into the law to make sure that we try to get at the gamesmanship, but then also provide an easily administered provision for the IRS.

The CHAIRMAN. Well, thank you.

Mr. DEBOER. A couple of maybe bigger-picture points first, if I may, Mr. Chairman. Senator Stabenow talked about how we can help Americans and American businesses. I think the first thing to keep in mind is not to do any harm to them. And some of the proposals, particularly on the revenue offset side, dramatically impact domestically based, capital-intensive industries that are conducted in pass-through format. And that is why we are so interested in this pass-through rate.

I understand Senator McCaskill's concern on the income to the top 1 percent. I would like to look at that data. I think that may include compensation for services to the entity, and we are very, very interested, as Mr. Lewis is, in making sure that that income does not come down and be taxed at a new lower rate.

We have done a significant amount of work here to try to look at the relationship between partners in a pass-through entity and how much service is provided to the entity itself. And our proposal at first blush is a little bit complicated. We are starting to reach out to staff and flesh it out.

And I guess for purposes of this hearing, I simply want to repeat what I said earlier in my opening statement. We are pledged to work with the committee, Senator Wyden, Senator McCaskill, and others, to make sure that with true compensation to the entity, there is no gamesmanship.

But the fact of the matter is, these pass-through entities do earn income, and that income, whether it is from rents in the real estate business or development fees or what have you, that income should be taxed lower if in fact corporate taxes are going to come down.

And one other thing that I would say: these pass-through entities are the vehicle of choice for startup businesses, they are the vehicle of choice for minority-owned businesses, and this is how most Americans who are interested in using their business acumen to develop jobs and expand our economy, this is the format that they do.

So encouraging activity in this area is very much commendable, and thank you for looking at this. It is a complicated issue, but one that I have no doubt you and your staff can tackle.

The CHAIRMAN. Well, thanks to all four of you. I think this has been a really interesting hearing. And I want to thank you all for your attendance and for your contributions here today.

As I noted last week, this committee's approach to tax reform will be methodical and inclusive. That is why hearings like the one we have just had today will be critically important as we continue to evaluate the tax code and continue with marking up a bill that will enact meaningful, durable, and efficient reforms.

My strong preference is that our evaluations and determinations and the final language of any bill we come up with will be bipartisan. And I intend to work towards that end. That means we have a lot of work to do, but I am optimistic that we can get it done.

For any of my colleagues who have written questions for the record, I ask that you submit them by the close of business on September 28th.

And with that, I again want to thank all four of you for being here and for your excellent testimony.

And we will recess until further notice.

[Whereupon, at 12:25 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Jeffrey D. DeBoer, President and Chief Executive Officer, The Real Estate Roundtable

Chairman Hatch, Ranking Member Wyden, and members of the committee, my name is Jeffrey DeBoer, and I am president and chief executive officer of The Real Estate Roundtable. Thank you for the opportunity to testify this morning on business tax reform on behalf of Roundtable members and the real estate industry.

The Real Estate Roundtable brings together leaders of the Nation's top publicly held and privately owned real estate ownership, development, lending, and management firms and leaders of major national real estate trade associations. Collectively, Roundtable members' portfolios contain over 12 billion square feet of office, retail, and industrial properties valued at more than $1 trillion; over 1.5 million apartment units; and in excess of 2.5 million hotel rooms. Participating trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business.

We agree with the members of this committee, House leaders, and the President that the time to reform the tax code is now. We share your commitment to pro-growth tax reform that will move our economy forward and help produce better jobs and bigger paychecks for all Americans. Our industry has appreciated the open dialogue and opportunity to work constructively with members and staff of this committee to ensure that tax reform achieves its full potential.

My comments are offered in the spirit of support for the tax reform effort, and they are aimed at ensuring the legislation successfully spurs economic growth without unintentionally discouraging entrepreneurship or creating unnecessary economic and market risks.

REAL ESTATE AND THE ECONOMY

Real estate is deeply interwoven in the U.S. economy and the American experience, touching every life, every day. Millions of Americans share in the ownership of the Nation's real estate, and it is a major contributor to U.S. economic growth and prosperity. Real estate plays a central role in broad-based wealth creation and savings for investors large and small, from homeowners to retirees invested in real estate via their pension plans.

Commercial real estate provides the evolving physical spaces in which Americans work, shop, learn, live, pray, play, and heal. From retail centers to assisted living facilities, from multifamily housing to industrial property, transformations are underway in the "built environment." Investment in upgrading and improving U.S. commercial real estate is enhancing workplace productivity and improving the quality of life in our communities.

Among its many and varied economic contributions, the real estate industry is one of the leading job creators in the United States, employing over 13 million Americans—more than 1 in every 10 full-time U.S. workers—in a wide range of well-paying jobs. Real estate companies are engaged in a broad array of activities and services. This includes jobs in construction, planning, architecture, building maintenance, management, environmental consulting, leasing, brokerage, mortgage lending, accounting and legal services, agriculture, investment advising, interior design, and more.

Commercial real estate encompasses many property types, from office buildings, warehouses, retail centers, and regional shopping malls, to industrial properties, hotels, convenience stores, multifamily communities, medical centers, senior living facilities, gas stations, land, and more. Conservatively estimated, the total value of U.S. commercial real estate in 2016 was $13 to $15 trillion, a level that roughly matches the market cap of domestic companies on the New York Stock Exchange. Investor-owned commercial properties account for roughly 90 percent of the total value, with the remainder being owner-occupied. Based on the latest data available from the Federal Reserve, U.S. commercial real estate is conservatively leveraged with about $3.8 trillion of commercial real estate debt.

Industry activity accounts for nearly one-quarter of taxes collected at all levels of government (this includes income, property, and sales taxes). Taxes derived from real estate ownership and its sale/transfer represent the largest source—in some cases approximately 70 percent—of local tax revenues, helping to pay for schools, roads, law enforcement, and other essential public services. Real estate provides a safe and stable investment for individuals across the country, and notably, retirees. Over $370 billion is invested in real estate and real estate-backed investments by tax-exempt organizations (pension funds, foundations, educational endowments and charities).

Commercial real estate is a capital-intensive asset, meaning that income-producing buildings require constant infusions of capital for acquisition and construction needs, ongoing repairs, and maintenance, and to address tenants' ever-changing technological requirements. Every homeowner in America who has had to repair a roof or to replace a furnace understands and appreciates that buildings are not a one-time, fixed expense. Real estate development, and the real estate improvements necessary for a building to avoid obsolescence, serves as a constant and powerful economic multiplier. Real estate capital expenditures ripple through the economy—creating jobs and generating economic growth.

Real estate investment is a long-term commitment and involves time horizons measured in 5 to 10 year increments, or longer—not the 3-month quarters that other industries and asset classes use to measure their performance. Consequently, from small towns to urban centers, real estate ownership in the United States represents a positive, bullish bet on America's economic future.

At the same time, the health and stability of U.S. real estate is heavily dependent on broader trends in the economy. Debt and deficits matter to real estate because of their impact on interest rates, the cost of borrowing, and the availability of private capital for investment and job creation. On one hand, some tax policies may cease to be pro-growth if they are financed through an increase in the Federal deficit. On the other hand, some revenue-raising options under discussion would slow growth and put downward pressure on wages and employment, so revenue neutrality for its own sake is not desirable.

Ultimately, the supply of real estate should be responsive to demand in order to support sustainable economic growth, and demand for real estate correlates with the overall level of economic activity. Thus, where goes the economy, so goes real estate. And where goes real estate, so goes the economy. The two are inextricably linked.

PRINCIPLES FOR SUSTAINABLE, PRO-GROWTH BUSINESS TAX REFORM

The real estate industry agrees that tax simplification and reform is needed and long overdue. We should restructure our Nation's tax laws to unleash entrepreneurship, capital formation, and job creation. At the same time, Congress should undertake comprehensive tax reform with caution, given the potential for tremendous economic dislocation. Tax policy changes that affect the owners, developers, investors and financiers of commercial real estate will have a significant impact on the U.S. economy, potentially in unforeseen ways.

A broad-based acceleration of economic growth through tax reform would boost real estate construction and development and spur job creation. However, Congress should be wary of changes that result in short-term, artificial stimulus and a burst of real estate investment that is ultimately unsustainable and counterproductive. Real estate investment should be demand driven, not tax driven. In short, we should avoid policies that create a "sugar high" that is fleeting and potentially damaging to our future economic health.

Because of the long-term commitment required in real estate investment, we are deeply concerned with how tax changes will affect jobs, wages, and economic activity not just tomorrow, but well into the future. In order to improve the economy's trajectory, growth should be predicated on sound reforms that change underlying economic conditions.

Fortunately, today's commercial real estate markets are grounded in strong fundamentals, as indicated by generally low vacancy rates, positive growth of rents, and stable net operating income. By most measures, commercial real estate conditions accurately reflect market supply and demand.[1] Sources of equity and debt capital are largely available for economically viable real estate projects. In some parts of the country and in certain markets, initial signs of oversupply are starting to emerge. These signs are typical and expected in a healthy real estate cycle.

We urge the Finance Committee to be mindful of how proposed changes in commercial real estate taxation could dramatically affect not only real estate investment activities but also job growth, retirement savings, lending institutions, pension funds, and, of course, local communities.

Positive reforms will spur job-creating activity. For example, tax reform that recognizes and rewards appropriate levels of risk-taking will encourage productive construction and development activities, ensuring that real estate remains an engine of economic activity. Tax reform can also spur job creation, and assist the Nation in achieving energy independence, by encouraging capital investments in innovative and energy-efficient construction of buildings and tenant spaces. Repealing the Foreign Investment in Real Property Tax Act (FIRPTA) would open up new sources of private capital for U.S. real estate and infrastructure projects. Authorizing States to impose sales tax collection requirements on remote sellers would end harmful tax discrimination against brick and mortar retailers and improve the economic wellbeing of local communities.

Alternatively, some reforms might prove counter-productive to long-term economic growth. Of major concern are proposals that could result in substantial losses in real estate valuation. Lower values could result from artificially stimulating excess supply, or adopting policies that increase the cost of capital through higher borrowing costs. Lower property values produce a cascade of negative economic impacts, affecting property owners' ability to obtain credit, reducing tax revenues collected by local governments and eroding the value of retirees' pension fund portfolios.

Thus, as much as we welcome a simpler, more rational tax code—and any associated improvements in U.S. competitiveness abroad—we continue to urge that comprehensive tax restructuring be undertaken with caution, given the potential for tremendous economic dislocation.

As history illustrates, the unintended consequences of tax reform can be disastrous for individual business sectors and the economy as a whole. A case in point is the Tax Reform Act of 1986, which ushered in over-reaching and over-reactive policies—in some cases on a retroactive basis. Significant, negative policy changes were applied to pre-existing investments. Taken together, these changes had a destabilizing effect on commercial real estate values, financial institutions, the Federal Government and State and local tax bases. It took years for the overall industry to regain its productive footing, and certain aspects of the economy never recovered.

A nostalgia for the Tax Reform Act of 1986 has grown and spread in Washington over the years. The 1986 Act is frequently cited as the model that 21st-century tax reform should strive to mimic. The actual economic evidence is much less favorable.[2] If there is a major lesson we can draw from the 1986 Act, perhaps it is this: revenue-raising policy changes tend to be much more enduring than reductions in tax

[1] The Real Estate Roundtable, "Sentiment Index: Second Quarter 2017" (May 5, 2017), available at: *http://www.rer.org/Q2-2017-RER-Sentiment-Index.*

[2] Both economic growth and job creation slowed dramatically in the United States for a number of reasons after the Tax Reform Act of 1986 took effect. In the 5 years before the legislation was adopted (1982–1986), the United States' real rate of economic growth averaged 3.55 percent. In the 5 years after enactment of the 1986 Act (1987–1991), the United States' economic growth rate averaged 2.64 percent. World Bank National Accounts Database (accessed September 14, 2017). Similarly, in the 5 years prior to its enactment (1982–1986), the United States created an average of 160,000 jobs per month. In the 5 years after its passage (1987–1991), the United States created 130,000 jobs per month, or 30,000 fewer than before its enactment. U.S. Department of Labor, Bureau of Labor Statistics, *Current Employment Statistics Survey* (accessed September 14, 2017).

rates, which are more easily undone to accommodate changing needs related to fiscal policy.[3]

We believe the four principles below should guide and inform your efforts to achieve a significant, pro-growth overhaul of the Nation's tax code:

1. Tax reform should encourage capital formation (from domestic and foreign sources) and appropriate risk-taking, while also providing stable, predictable, and permanent rules conducive to long-term investment;
2. Tax reform should ensure that tax rules closely reflect the economics of the underlying transaction—avoiding either excessive marketplace incentives or disincentives that distort the flow of capital investment;
3. Tax reform should recognize that, in limited and narrow situations (*e.g.,* low-income housing and investment in economically challenged areas), tax incentives are needed to address market failures and encourage capital to flow toward socially desirable projects; and
4. Tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets.

In short, rational taxation of real estate assets and entities will support job creation and facilitate sound, environmentally responsible real estate investment and development, while also contributing to strong property values and well-served, livable communities.

POTENTIAL ELEMENTS OF BUSINESS TAX REFORM AND THEIR IMPACT ON REAL ESTATE

In June of last year, House Ways and Means Committee Chairman Kevin Brady (R–TX), House Speaker Paul Ryan (R–WI), and the House Republican Conference put forward A Better Way, a bold tax reform proposal aimed at creating a modern tax code. We support the blueprint's underlying objectives, including the desire to reform the tax system to promote economic growth, capital formation, and job creation. In addition, this committee has explored several tax reform options, including corporate tax integration. Senator Wyden has released a number of tax reform discussion drafts related to various issue areas. In April, the President's economic team released a one-page outline of the administration's tax reform priorities. In July, congressional leaders, the Treasury Secretary, and the Director of the National Economic Council issued a joint statement identifying several areas of agreement. While the details of tax reform remain uncertain, these events have shed light on the potential contours of comprehensive tax legislation. The remainder of my testimony will focus on specific elements of business tax reform under consideration. Of course, our views and input will continue to evolve as additional information and details are made available.

The Business Interest Deduction—An Ordinary and Necessary Expense Critical to Real Estate Ownership, Development, and Financing

The House Blueprint and other reform proposals have advocated limiting or repealing the deductibility of net interest expense for business-related debt. Restrictions on interest deductibility would cause enormous damage to U.S. commercial real estate by dragging down property values and discouraging new investment.

Access to financing and credit is critical to the health of U.S. real estate and the overall economy. As a general matter, business interest expense is appropriately deducted under the basic principle that interest is an ordinary and necessary business expense. For real estate in particular, because the vast majority of real estate is held in pass-through form, the interest deduction does not result in a tax-induced distortion in investment financing decisions.

The ability to finance productive investment and entrepreneurial activity with borrowed capital has driven economic growth and job creation in the United States for generations. America's capital markets are the deepest in the world and provide our economy with a valuable competitive advantage.

Borrowing is not limited to large companies—four out of five small businesses rely on debt financing. Businesses rely on credit for working capital and to weather

[3] The 28 percent maximum individual income tax rate in the Tax Reform Act of 1986 lasted 3 years before increasing to 31 percent in a bipartisan budget agreement. Three years later, in 1993, the maximum income tax rate increased again to 39.6 percent. In contrast, the base broadeners, such as the lengthening of cost recovery schedules and limitations on passive activity losses, became permanent fixtures of the tax code.

shifts in demand. Limiting the deductibility of interest would increase the cost of capital, discouraging business formation and making it harder to grow into larger businesses. Over time, rising interest rates will magnify the harm, potentially leading to greater financial volatility and higher default rates.

The notion that business interest should be deductible is deeply ingrained in our economic system and precedes the modern income tax itself. The corporate income tax of 1894 included a deduction for business interest. In both an income tax system and a cash flow tax system, business interest expense is appropriately deducted under the basic principle that interest is an ordinary and necessary business expense. Any economic bias in favor of debt-financed investment principally relates to the tax penalty on the shareholders of C corporations, who are double-taxed on their equity investments. Real estate is held typically in pass-through form, and the interest deduction does not result in a tax subsidy for debt-financed real estate investment.

Repealing or imposing limits on the deductibility of business interest would fundamentally change the underlying economics of business activity, including commercial real estate transactions. This could lead to fewer loans being refinanced, fewer new projects being developed, and fewer jobs being created. Legislation altering the tax treatment of existing debt could harm previously successful firms, pushing some close to the brink of insolvency or even into bankruptcy. By increasing the cost of capital, tax limitations on business debt could dramatically reduce real estate investment, reducing property values across the country, and discouraging entrepreneurship and responsible risk-taking.

The burden of changing the deductibility of interest may fall disproportionately on entrepreneurs and small developers—those most likely to own properties in small and medium-sized markets—because they use greater leverage to finance their activities and lack the deep portfolio of assets to absorb the losses generated from expensing. Restrictions may also impede efforts to attract private capital for infrastructure investment.

Private-sector economists have modeled for the industry the impact that elimination of the deductibility of business interest would have on real estate investment and property values. They examined tax reform based on the rates and structure of the House Blueprint, but without the immediate expensing of structures. Their research suggests the negative impact on property values and the after-tax returns on real estate investment would be severe. For all of these reasons, Congress should ensure that tax reform preserves the current tax treatment of business interest.

Cost Recovery and the Expensing of Capital Investment—Tax Rules Should Track the Actual Economics of Real Estate Ownership

Rather than taxing businesses on their net income, the House Blueprint seeks to tax businesses on their net cash flow. For a domestic business, the full cost of a new investment would be recovered (deducted) immediately, rather than recovered (depreciated) over the economic life of the investment. The underlying expectation is that the shift to cash flow taxation will spur growth by reducing the tax burden on new investment. While the joint statement in July appeared to move away from a complete cash flow business tax system, it did promise “unprecedented” expensing of capital investment.

Economic studies suggest that expensing in the abstract is a powerful, pro-growth tax policy. Personal property and certain real estate assets already benefit from accelerated and bonus depreciation. Today, 90 percent of the cost of an investment in 3-year property is recovered for tax purposes within the first 18 months of its use. Five-year property is 78 percent recovered in the first 18 months. Even 7-year property is nearly 70 percent recovered in the first 18 months.[4] Expensing these short-lived asset classes makes sense. Current tax policy is already well on the way towards the expensing of equipment and machinery, and full expensing of these assets may offer significant tax simplification advantages. Alternatively, the committee could consider proposals aimed at simplifying cost recovery for short-lived assets, such as Senator Wyden’s pooling proposal.

However, real estate is different from these other capital assets. Structures are long-lived, require constant infusions of capital, and typically sell for a gain. Thus,

[4] David Mericle and Dan Stuyven, “Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing” (Goldman Sachs Economics Research, November 30, 2016). *See also* Ryan Corcoran et al., “Understand Common Complexities When Applying Bonus Depreciation,” RSM Insight Article (February 7, 2017).

real estate is subject to much longer recovery periods and slower recovery methods. Expensing real estate would constitute a much more dramatic shift from current law with unknown consequences. The challenges associated with transitioning real estate to an expensing regime are immense and, likely, prohibitively costly.

The Tax Foundation's own analysis of the economic impact of immediate expensing reveals that nearly 73 percent of the boost to economic growth generated from the full expensing of capital investment would come directly from new real estate construction, development, and investment.[5] While real estate represents a large and important share of the U.S. economy, it is not ¾ of the overall pie. The Tax Foundation analysis suggests that the boost to GDP from immediate expensing would not drive a broad-based, demand-driven increase in economic activity. On the contrary, it suggests that any boost to short-term growth would stem from an untested tax policy that is likely to over-stimulate real estate markets.

The industry concerns with expensing are based on historical experience. Accelerated depreciation of real estate in the early 1980s led to tax driven, uneconomic investment. Tax-motivated stimulation of real estate construction that is ungrounded in sound economic fundamentals, such as rental income and property appreciation expectations, creates imbalances and instability in real estate markets. No other major country in the world has immediate expensing of real estate. The market implications of expensing real estate are risky, untested, and unpredictable. The negative consequences could harm State and local communities (through reductions in State and local property tax revenue), the financial security of retirees (through pension investments tied to real estate), and the banking system (through the declining value of real estate on bank balance sheets and systemic risk to the financial system).

The House Blueprint proposes to deviate from cash flow taxation in two key ways that would have critical implications for real estate. First, land would not qualify for immediate expensing, only the value of structures. Second, as discussed above, businesses could not deduct currently their net interest expense. As a result, two major expenses associated with investing in real estate—the cost of the underlying land and the cost of borrowing capital to purchase the real estate—would be excluded from the basic architecture of the cash flow tax system.

Land represents a major share, on average roughly 30 percent, of the value of real estate. The House Blueprint offers no express rationale for the exclusion of land from immediate expensing. The two suggestions offered informally to-date have been that land is a "non-wasting" asset and "we're not making any more of it." However, the actual economic life of an asset and its status as a manufactured good is irrelevant to a system that seeks to tax net cash flow. Under the Blueprint's own terms, land should qualify for expensing. Denying taxpayers' ability to expense land would create the very same economic distortions that the Blueprint is seeking to remove from the tax code. It would shift resources to other asset classes for reasons that are purely tax-motivated. In addition, it would create new geographic disparities and distortions based on the relative share of land in the cost of real estate.

Current cost recovery rules do need reform. The real estate industry favors tax rules that closely reflect the economics of transactions. Existing depreciation schedules are too long. The Massachusetts Institute of Technology (MIT) recently conducted a comprehensive study on the rate of economic depreciation for commercial real estate.[6] MIT analyzed over 120,000 actual transactions and 13,000 land/development sites and developed a model of the entire life cycle of commercial property. For the first time, ongoing capital expenditures were added to the depreciation analysis. The research makes great strides in separating the value of land from the value of structures. The MIT study controlled for property and location characteristics much more extensively than any prior published research. The study is a tremendous improvement over prior government studies, which rely on data from the 1960s and 1970s. The bottom line is that the appropriate straight-line depreciations periods for real estate should be closer to 20 years, not 27.5 or 39 years. Shortening the straight-line depreciation of real estate to 20 years, rather than expensing, would spur investment that is sustainable and economically sound.

[5] Stephen J. Entin, "Tax Treatment of Structures Under Expensing" (May 24, 2017).

[6] Professor David Geltner and Sheharyar Bokhari, "Commercial Buildings Capital Consumption in the United States," (MIT Center for Real Estate, November 2015); *see also* Andrew B. Lyon and William A. McBride, "Tax Policy Implications of New Measures of Building Depreciation," *Tax Notes* (June 20, 2016).

With respect to depreciation "recapture," the tax law should continue to recognize that a portion of the income received on the sale of real estate reflects the appreciation of the underlying land and is appropriately taxed at the reduced capital gains rate.

Pass-Through Reform: Tax Changes Should Promote Growth and Entrepreneurship for All Forms of Business Activity

Our pass-through regime is a competitive strength of the U.S. tax system, not a burden. Entity choice is a differentiator that contributes to our entrepreneurial culture. The expansion of the pass-through sector has allowed American businesses to avoid the rigid nature of the corporate form and its many demands on legal structure and governance that are unrelated to tax considerations. Partnership tax rules promote job creation by increasing business flexibility and facilitating the pooling of expertise, capital, and know-how under one roof. Partnerships can allocate the risks and rewards of the enterprise as they choose, provided the distribution of profits and losses have substantial economic effect. The result is a more dynamic business environment that promotes innovation, productivity, and appropriate levels of risk taking that are responsive to the needs of both limited investors and general partners.

Real estate investment, new construction and development, and rental income constitute a significant share of pass-through business activity. Half of the country's nearly 4 million partnerships are real estate partnerships. Pass-through entities (partnerships, LLCs, and S corporations), as well as real estate investment trusts (REITs), are ideal for real estate investment because they give investors flexibility in how they structure the risks and rewards of the business.

These partnerships include a wide variety of arrangements that range from two friends who purchase, improve, and lease a modest rental property to a large private real estate fund that raises capital from sophisticated institutional investors. Similarly, listed REITs provide the opportunity for small investors to invest in large scale, diversified real estate operations using the same single tax system available to partners in partnerships.

Recent tax reform proposals from congressional leaders and the administration would establish a special tax rate applicable to the business income of pass-through entities and sole proprietorships. Care should be taken when creating a new rate structure for pass-throughs, including REITs, to avoid an entity level tax or arbitrary rules that penalize general partners or raise the tax burden on carried interest.

The pass-through rate should seek to spur economic growth and job creation by reducing the tax burden on business formation and entrepreneurship. With this in mind, a special tax regime for pass-through entities should take into account the types of activity and income that most commonly arise in noncorporate form. The pass-through rate should avoid "cliffs," phase-outs, and carve-outs that create new economic distortions, discourage business growth, or aim to steer investment to certain government-favored activities. Similarly, the pass-through rate should avoid asset or revenue tests that ignore differences in the capital intensity and financing structures of certain industries.

Further, tax reform should maintain equivalence with respect to the taxation of rent and interest, whether the rent or interest is collected through a partnership, a limited liability company, an S corporation, or a REIT. Under current law, a dollar of rental or interest income, whether received through a REIT or a pass-through entity such as a partnership, has the same rate, character and timing for tax purposes. A shift away from equivalence would discriminate against REIT-based rent or interest received by owners of the REITs, even though REITs are not permitted to keep the rent or interest and must pay it out annually to owners.

Lastly, the pass-through rate should avoid changes that unintentionally reduce incentives for entrepreneurial risk-taking and capital formation. For example, the pass-through rate should preserve a partnership's ability to extend participation in the capital appreciation of the business and its assets to a general partner who bears risk and contributes sweat equity. The character of income should continue to be determined at the partnership level.

The Real Estate Roundtable's Tax Policy Advisory Committee has produced a white paper that suggests one possible approach for how to design a reduced tax rate applicable to pass-through business income.

In short, rather than specifically seeking to measure reasonable compensation or create an arbitrary rule that taxes a specific percentage of pass-through income as ordinary and a percentage at the business rate, the proposal looks at the relationships between the partners. If a partner spends only a *de minimis* number of hours providing services, then all of the partner's income is taxed at the pass-through rate. If there are limited partners earning the same return as the partner providing services (*i.e.,* providing a "benchmark"), then all the service partner's income is taxed at the pass-through rate. Finally, if there is no benchmark provided by outside investors, then the service partner would qualify for the pass-through rate to the extent of a specified return on investment (perhaps 12 percent). Amounts above the specified percentage would be taxed as ordinary income.

This approach would provide greater certainty to taxpayers at the outset of a business venture. It would eliminate many of the administrative challenges associated with measuring reasonable compensation and create fewer opportunities for abuse. The white paper acknowledges that there may be situations where an approach based on reasonable compensation or other factors may be appropriate and more equitable. The proposal only relates to the operating income of a pass-through business.

Capital Gains and Entrepreneurial Risk-Taking—A Key Differentiator That Encourages Vibrant and Dynamic Economic Growth

The tax code has historically encouraged and rewarded risk-taking and entrepreneurship, and our tax rules have recognized that risk can involve much more than the contribution of capital or cash. Low capital gains tax rates help stimulate economic growth, increase investment, and create jobs. In addition to encouraging risk-taking and entrepreneurship—core strengths of the American economic model—low capital gains rates reduce the tax-driven "lock up" of assets that prevents properties from being put to their best and most efficient use. Low capital gains taxes also minimize distortions that result from taxing inflation-induced, uneconomic gains.

Because of the capital-intensive nature of long-lived real estate assets, real estate partnerships often bring together (1) a general partner who manages the business in exchange for an annual management fee and a share of the profits and (2) investors who serve as limited partners and contribute capital. Incorporating "carried interest" into the partnership structure allows entrepreneurs to match their expertise and risk assumption with financial partners and aligns the parties' economic interests so that entrepreneurial risk taking is viable.

Tax reform should preserve the longstanding rule that determines the character of partnership income at the partnership level. Changes to carried interest taxation would instill substantial uncertainty in the marketplace and have a chilling effect on capital investment. Congress should reject legislation that specifically targets capital gain on real estate sales (including carried interest), and any comprehensive tax restructuring should continue to encourage capital formation and appropriate entrepreneurial risk taking for the benefit of the broader economy and job creation.

Like-Kind Exchanges: A Valuable Tool for Business Expansion, Growth, and Job Creation

Under current law, section 1031 of the tax code ensures that taxpayers may defer the immediate recognition of capital gains when property is exchanged for property of a like kind. In order to qualify for full tax deferral, a like-kind exchange transaction must involve property used in a trade or business, or held as an investment, and all proceeds (including equity and debt) from the relinquished property must be reinvested in the replacement property. Section 1031 is used by all sizes and types of real estate owners, including individuals, partnerships, LLCs, and corporations. While the House Blueprint does not expressly address like-kind exchanges, we understand some policymakers view immediate expensing as a viable replacement for section 1031 of the tax code. We disagree.

Real estate like-kind exchanges generate broad economic and environmental benefits, and section 1031 should be preserved without new limitations on the deferral of gains. Exchanges spur greater capital investment in long-lived, productive real estate assets and support job growth, while also contributing to critical land conservation efforts and facilitating the smooth functioning of the real estate market. Without section 1031, many of these properties would languish underutilized and short of investment because of the tax burden that would apply to an outright sale. Recent academic research analyzing 18 years of like-kind exchange transactions involving real estate found that they lead to greater capital expenditures, investment, and tax revenue while reducing the use of leverage and improving market liquidity.[7] Another study by EY concluded that new restrictions would increase the cost of capital, discourage entrepreneurship and risk taking, and slow the velocity of investment.[8] As currently understood, the Blueprint would not fully replicate the benefits of section 1031, particularly to the extent that the land component of real estate remains ineligible for immediate expensing.

State and Local Tax Deduction: Vital to Economic Health and Well-Being of Local Communities

State and local taxes are the principal source of financing for schools, roads, law enforcement and other infrastructure and public services that help create strong, economically thriving communities. Throughout the country, real estate is the largest contributor to the local tax base. Most State and local taxes, including real estate taxes, are deductible from Federal income. Eliminating the deductibility of State and local taxes could disrupt demand for commercial real estate in many parts of the country while raising taxes on millions of Americans. It would shift power away from local communities in favor of the Federal Government. The deductibility of State and local taxes is grounded in the Constitution, federalism, and States' rights. The State and local tax deduction prevents an erosion of local governance and decision-making by prohibiting the Federal Government from double-taxing amounts already taxed at the State and local level. The burden of the change will fall disproportionately on those regions that generate the most tax revenue for the Federal Government—and the reduced demand for commercial real estate in certain regions could lower property values and limit the ability of the industry to continue creating jobs and driving economic growth.

Transition Rules/Technical Adjustments: Tax Reform Must Avoid Past Mistakes, Provide Well-Designed Transition Regime

The $13–$15 trillion of existing commercial real estate stock and $3.8 trillion of commercial real estate mortgage debt creates immense transition challenges for tax reform. The stock of existing commercial real estate is more than 12 times the size of total annual private investment in equipment and machinery. Retroactive tax changes and poorly designed transition rules in the Tax Reform Act of 1986 triggered a real estate depression and economic recession. Those reforms (primarily, the passive activity loss rules) were minor compared to the types of changes contemplated in the House Blueprint. Grandfathering existing investment under the current rules, alone, is not sufficient if new real estate investment is subject to a dramatically different regime. Tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets.

Additionally, care should be taken to adjust the REIT rules appropriately to ensure that the congressional intent to allow average investors to access high quality commercial real estate is not hampered.

Foreign Investment in Real Property Tax Act (FIRPTA): Reform Could Boost U.S. Real Estate and Infrastructure by Repealing Outdated Barriers to Foreign Capital

The punitive Foreign Investment in Real Property Tax Act (FIRPTA) regime subjects gains on foreign equity investment in U.S. real estate or infrastructure to a much higher tax burden than applies to a foreign investor purchasing a U.S. stock or bond, or an investment in any other asset class. In addition to the tax burden, the withholding and administrative filing requirements associated with FIRPTA are frequently cited by foreign taxpayers as principal reasons for avoiding the U.S. real estate market. FIRPTA is a major impediment to greater private investment in both U.S. real estate and infrastructure.

In 2015, Congress passed the most significant reforms of FIRPTA since its passage in 1980. Congress should build on the recent success by repealing FIRPTA outright as part of tax reform. Unleashed by FIRPTA's repeal, capital from abroad would create jobs by financing new real estate developments, as well as the upgrading and rehabilitation of existing buildings. Architects, engineers, construction firms, subcontractors, and others would be put to work building and improving commercial buildings and infrastructure.

[7] Professors David C. Ling (University of Florida) and Milena Petrova (Syracuse University), "The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate" (June 2015), available at: *http://warrington.ufl.edu/departments/fire/docs/paper_Ling-Petrova_EconomicImpactOfRepealingOrLimitingSection1031.pdf.*

[8] EY, "Economic Impact of Repealing Like-Kind Exchange Rules" (November 2015), available at: *http://www.1031taxreform.com/1031economics.*

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Because commercial real estate is ubiquitous, it is easy to overlook its positive connection to the fabric of our Nation. Commercial real estate is where America lives, works, shops, plays, and invests. The right tax policy can, for the benefit of all Americans, help commercial real estate: create and maintain good jobs, lift retirement savings, reduce energy consumption, and improve the quality of life in local communities.

The Real Estate Roundtable is fully committed to working with the Senate Committee on Finance to achieve a bold business tax reform outcome that serves the overall economy. We appreciate your consideration of these issues.

QUESTIONS SUBMITTED FOR THE RECORD TO JEFFREY D. DEBOER

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

Question. Mr. DeBoer, in your testimony you cite the Tax Foundation's analysis of the economic impact of immediate expensing, which found that 73 percent of the gains in economic growth from full expensing would come from real estate construction, development, and investment. You raised some serious concerns about full expensing, indicating that it would "over-stimulate" real estate markets. Would you tell us more about the impacts of full expensing on the real estate industry?

Answer. Senator, today, economic fundamentals are driving real estate investment decisions. Following a period of healthy markets with low vacancies, rising rents, and stable operating income, some early signs of oversupply are emerging in certain markets. While there are important exceptions (*e.g.,* foreign investors and FIRPTA), the tax code is not inhibiting real estate activity.

In an income tax system, cost recovery rules should align with the economic life of income-producing capital assets. Real estate is a long-lived asset. Full and immediate expensing of commercial real estate would distort the economics of real estate investment decisions. Expensing would encourage developers to construct new buildings, regardless of whether there is sufficient economic demand for the space, and lead to unsustainable, tax-motivated investment. In addition, full expensing would create large tax losses that create incentives for transactions that have nothing to do with the underlying commercial real estate needs of our property markets. Lastly, full expensing would generate enormous transition challenges with respect to the existing $13–15 trillion in commercial real estate in the United States.

The Roundtable's concern with over-stimulative tax policy is well-grounded and based on prior experience. The Economic Recovery Tax Act of 1981 contained significant new tax incentives for commercial real estate construction, including greatly accelerated cost recovery schedules. Not surprisingly, the private sector responded to these incentives. In just the 2 years between 1983 and 1985, the constant dollar value of commercial construction increased 50 percent (Lynn Browne and Karl Case, *How the Commercial Real Estate Boom Undid the Banks,* Federal Reserve Bank of Boston Conference Proceedings, vol. 36, 57–113, 1992). The distribution of investment in the economy was artificially skewed toward commercial real estate. About 14 percent of total nonresidential investment was devoted to commercial construction in the mid-1980s, compared to 8 percent in the second half of the 1970s. *Id.* While other factors also contributed to overbuilding, such as bank lending practices and the availability of tax shelters, accelerated cost recovery is widely regarded as a principal factor. *See* D'Ann Petersen et al., "The Role of Tax Policy in the Boom/Bust Cycle of the Texas Construction Sector," Federal Reserve Bank of Dallas, Working Paper 94–13 (1994); Raymond E. Owens, "Commercial Real Estate Overbuilding in the 1980s: Beyond the Hog Cycle," Federal Reserve Bank of Richmond, Working Paper 94–06 (1994).

The surge in uneconomic, tax-driven investment was ultimately unsustainable, and Congress reversed the tax policies that contributed to the over-construction in the Tax Reform Act of 1986. The policies enacted in 1986 were over-reactive, and in some cases, applied retroactively. Policymakers should avoid making similar mistakes in 2017. Tax reform should shorten real estate cost recovery rules to reflect the useful live of commercial real estate structures, which MIT research suggests is closer to 20 years.

Question. I have heard from my colleagues across the aisle the parade of horribles that will ensue if Congress enacts a proposal to provide a lower business income tax rate for pass-through entities—that it will only benefit the rich and that it will, according to Dr. Marron, "inspire tax avoidance." And yet two of the witnesses came to the table with thoughtful approaches on how to address the concerns that compensation, or wage income, that is taxed at ordinary income tax rates will be inappropriately recharacterized as business income subject to a preferential business income tax rate. I'd like to have you comment on their proposals, whether the concerns raised are legitimate but perhaps overblown, and provide your thoughts on administrative issues associated with their proposals.

Answer. Properly structured, a reduced pass-through rate has extraordinary potential to drive new investment and growth in entrepreneurial businesses. These businesses—start-ups, entrepreneurs, small and mid-sized firms and developers—represent the segment of the economy where access to affordable financing, capital, and credit can pose a real challenge. A reduced rate on pass-through income will not only spur entrepreneurial activity and job creation, it will provide small, mid-sized, and closely held businesses with a power tool to attract the outside investment they need to fuel their growth.

Central to the committee's challenge is designing a reduced pass-through rate that avoids tax abuses, such as disguising income as business income when it is properly treated as wages. Here, distinguishing an owner-operator's personal services income from his or her income attributable to a capital investment in the business is a very important issue. Fortunately, existing tax law provides rules that can readily be applied to this problem.

First, for an owner who provides no services—or only *de minimis* services like hiring a full-time CEO or developing or approving a basic business plan to govern the entity—100% of that owner's income should qualify for the reduced rate. This is similar to a rule currently contained in longstanding proposed regulations applicable to defining what properly constitutes self-employment income (*i.e.,* personal services income) as opposed to investment income for the owner-operator of a limited partnership or limited liability company.

Second, for an owner who provides substantial services, such as a full-time CEO, who also invests capital in the entity on the same terms as limited investors, the return to capital that the owner-operator receives on that investment should qualify for the reduced rate. There cannot be "disguised compensation" if the owner-operator is getting a return on his capital investment that is no higher, dollar for dollar, than the return passive investors are receiving. This is also similar to a well-accepted rule in the longstanding proposed regulations governing self-employment income of limited partners and limited liability company members. Those rules recognize that one can be both a "general partner" and a "limited partner" in the same entity, with different rules for those different streams of income.

Third, where there is no third-party benchmark under the second rule, there are several options. The IRS could apply a "reasonable compensation" requirement. This is done currently for S corporations to ensure that they pay their owner-operators a reasonable amount of FICA wages. However, as many have suggested, this may prove cumbersome and difficult to enforce. Instead, we think that Congress could simply provide that a specified portion of the owner-operator's income—equal to a statutory rate of return (such as 12 percent) applied to his or her capital investment in the entity—would qualify for the reduced tax rate, with the rest all treated as personal services income. In effect, instead of measuring reasonable compensation, this approach looks to the hard facts of how much capital the taxpayer has invested, and applies a statutory rate of return to that amount.

We would be happy to provide the committee with more detailed illustrations of how this approach might work with more complex examples involving, for example, debt-financed contributions, distributions of cash or property, temporary investments in reserves or portfolio assets and so forth. We are confident that the technical rules can be drafted so as to eliminate any realistic possibility of abuse, but also to be transparent and easily administered by taxpayers and the IRS.

Question. Mr. DeBoer, you noted in your testimony that "tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets." I would go even further and note that transition in this tax reform effort needs to consider all sectors of the economy. You've noted that grandfathering provisions may not by sufficient. Would you elaborate on the transition considerations that you think Congress should take into account?

Answer. A well-designed transition regime is critically important to the success of tax reform. A new tax system may appear promising in concept, but fail to take into account the complexity of the U.S. economy, including the market structures and forces that have developed around existing tax rules. The Real Estate Roundtable estimates existing U.S. commercial real estate is worth between $13–15 trillion. Because commercial real estate has tax lives that are measured in decades, rather than years, poorly designed transition rules pose a greater risk to real estate owners and investors than other industries.

Failing to provide a smooth transition from one set of rules to the next could cause significant financial loss and severe hardship for taxpayers who invested capital and sweat equity based on longstanding tax laws and principles. Moreover, because real estate is so interwoven in the U.S. economy, harm to property values or real estate markets could create a cascade of negative consequences for the broader economy—from retirement benefits and local communities to the financial system and job growth.

Different tax treatment between new and old investment risks creates an un-level and unfair business environment. For example, if a newly constructed building was 100-percent expensed and an existing building remained subject to current depreciation schedules, the owner of the new building would have a government-created competitive advantage and could lease space at a lower cost while maintaining profitability. The government should avoid distorting markets by tipping the scale in favor of one taxpayer over another.

Grandfathering provisions can prevent unnecessary harm to existing investments that were made based on a set of expectations regarding the tax law. However, depending on their design, grandfathering provisions can also have the unfortunate effect of locking in existing ownership structures and creating new economic distortions. Real estate is already an illiquid asset, relative to stocks and bonds. If tax reform reduces market liquidity even more, it could reduce net investment and put downward pressure on property values. The lock-up effect could prevent properties from getting into the hands of new owners with the time, resources, and desire to upgrade and improve the property. Healthy liquidity in the real estate marketplace contributes positively to capital expenditures as new owners look to increase the value of their investment by upgrading and improving the building. The result is job creation and economic growth.

Tax reform transition rules should seek to put taxpayers on a level footing without penalizing business and investment decisions made prior to enactment. To the extent that tax reform rewards capital formation, the incentives should extend to both new and existing investment. Lastly, the rules should be permanent—thereby providing industries with long time horizons, such as real estate, with the policy certainty they need when putting capital at risk.

Question. Mr. DeBoer, on page 7 of your written testimony, you say that some private-sector economists modeled for the real estate industry the House Blueprint, "but without the immediate expensing of structures." You go on to cite the study showing that there would be a negative impact on property values. But if the economists' model did not allow the immediate expensing of structures, isn't that quite different from what the House proposed?

Answer. The economic modeling referenced in my testimony examined the impact of reducing or eliminating the deductibility of business interest while maintaining current depreciation rules. The House Blueprint released in June 2016 would have provided for the full and immediate expensing of structures. The unified framework released last month excludes structures from immediate expensing. Extension of expensing to structures likely would have an impact on property values, particularly in the short term. Key considerations include: (1) whether the owner has other income to absorb the losses generated by immediate expensing, and (2) the parameters of the loss carryforward interest rate adjustment (the House Blueprint provided an interest rate adjustment to loss carryforwards to preserve their economic value going forward, but lacked sufficient detail to accurately model the provision).

Industry concerns with the immediate expensing of real estate principally relate to the potential for over-stimulation of real estate construction that is ungrounded in economic demand. These concerns are not captured in the cash-flow model used to measure changes in internal rates of return and property values, or for that matter, in the outside macroeconomic models that estimate the impact of tax reform on overall economic activity. Macroeconomic models generally do not account for the negative consequences of excessive investment.

Question. Mr. DeBoer, you said a lot of things about the State and local tax (SALT) deduction I would like to ask you about.

You said that “Eliminating the deductibility of State and local taxes could disrupt demand for commercial real estate.” When I hear proposals to eliminate the SALT deduction, I usually take this to mean the itemized deduction for State/local taxes paid by residences. I have assumed that such proposals, if enacted, would still allow the SALT deduction as to SALT taxes paid in the business context or to the extent paid in the production of income. Is my assumption correct? If it is, it’s not clear to me that eliminating the SALT itemized deduction could disrupt demand for commercial real estate. Please explain.

Answer. Senator, we agree that any elimination of the deductibility of State and local taxes should not alter the deductibility of taxes paid in the context of a trade or business, or to the extent they are incurred in the production of income.

We are concerned that elimination of the deductibility of State and local income and property taxes will lead to economic dislocation that reduces demand for commercial real estate in affected regions. While tenants and workers may be mobile and able to relocate, office buildings and shopping centers are not. The dislocation that results from repealing the State and local tax deduction will disproportionately hurt immobile assets, including commercial real estate and infrastructure. In these regions, economic development has relied, at least partially, on longstanding tax rules that allow taxpayers to offset a portion of the cost of State and local institutions and governance on their Federal tax return. Changing the rule now penalizes taxpayers, such as real estate owners, who deployed capital with an expectation that Congress would not change the fundamental precepts of Federal taxation.

Question. You also write that, “The deductibility of State and local taxes is grounded in the Constitution.” Please explain that.

Answer. When Congress enacted the income tax, it built the deductibility of State and local taxes into the tax system, from the outset, in recognition of the principle of federalism underlying the Constitution and the compact that formed the Nation. The original framers of our income tax understood and acknowledged that Washington, DC did not have a preemptive claim on the resources needed to sustain government. By making State and local taxes deductible on the Federal returns, Congress appropriately wanted to give State and local governments priority over the pool of available tax revenues.

Question. You write that, “The State and local tax deduction prevents an erosion of local governance and decision-making by prohibiting the Federal Government from double-taxing amounts already taxed at the State and local level.” When I hear about “double taxation,” I often think of the foreign tax credit. The foreign tax credit is often justified on the grounds of it preventing double taxation. So, would you think there should be a SALT credit? Is a credit necessary to alleviate double taxation? If not, then does this suggest that the foreign tax credit is not necessary for alleviating double taxation and that a foreign tax deduction would be sufficient?

Answer. In States with an individual income tax, income is double-taxed. However, the State and local tax deduction allows most taxpayers not subject to the AMT to reduce their Federal income by the amount of State and local income taxes paid. The effect is to reduce (but not eliminate) the amount of income that is subject to double taxation. A credit could eliminate the double taxation for most taxpayers, but we are not seeking a tax credit for State and local taxes paid (nor are we advocating that the foreign tax credit be replaced with a foreign tax deduction). Rather, in recognition of the importance of the existing State and local tax deduction to local communities and economic development in many regions of the country, we encourage Congress to retain the deduction in its current form.

Question. Mr. DeBoer, I appreciated that in your testimony you state that “C corporations . . . are double-taxed on their equity investments.” I agree with you. That’s why I have been working on a corporate integration project for some time now. Has the Real Estate Round Table taken a position on corporate integration?

Answer. Real estate is largely held in pass-through form, either directly or through a partnership, LLC, or S corporation, or through a REIT, which is taxed like a pass-through entity. The Roundtable does not have a formal position on corporate integration, but generally supports the simplification and streamlining of our business tax system. Although REITs are organized as C corporations, they receive a 100 percent dividends-paid deduction provided various requirements are met, and therefore represent a potential model for full corporation integration. However, the dividends-paid deduction for REITs serves a specific policy objective, providing smaller, retail investors an opportunity to invest in professionally managed commercial real estate.

One potential concern with corporation integration is the policy changes necessary to finance the transition to an integrated system. We do not believe that Congress should raise taxes on real estate and other industries that operate in pass-through form to help offset the cost of integration. In addition, reducing the tax burden on equity investment should not come at the expense of higher taxes on debt-financed investment. Interest is a cost of doing business and should continue to be fully deductible.

Question. Mr. DeBoer, you write that, "Lower property values produce a cascade of negative economic impacts." However, many policy-makers, at all levels of government, pursue policies to allow for more "affordable" housing. I interpret affordable to mean lower-priced. So, is the attempt to create affordable housing options a mistake? Does that have negative economic impacts?

Answer. Adequate supply of affordable housing is critically important and lacking in many parts of the country, as Senator Cantwell noted during the hearing. While real estate generally should be taxed on an economic basis, affordable housing is one area where tax incentives fill an important void left unserved by market forces alone. The costs of building and providing new housing—obtaining financing, acquiring land, paying architects and engineers, constructing buildings, maintaining them, and servicing the loans—exceed what many low and even moderate-income renters can afford to pay. Provisions such as the low-income housing tax credit represent an efficient, market-driven mechanism to increase the supply of affordable housing with minimal government interference. It should be preserved and potentially expanded in tax reform.

The reference to the negative economic effects of lower property values relates to the potential damage caused by government policies that cause existing real estate values to decline. Affordable housing that is the result of new supply coming to the market and meeting an unmet economic need is desirable. In contrast, lower property values that result from policy changes that increase the tax burden on current property owners are counterproductive. Lower property values reduce the tax base for local communities. Lower property values result in less income for pension funds and education endowments that invest in real estate. Lower property values threaten the balance sheets of banks and financial institutions, increase the likelihood of defaults, and create the potential for new systemic economic risks.

QUESTIONS SUBMITTED BY HON. RON WYDEN

Question. Mr. DeBoer, real estate is a long-term investment, often stretching decades. So it stands to reason that the long-term health of the economy is critical for your industry to do well. Would you agree? So if the House Republican tax plan were enacted and the analysis by Dr. Marron's colleagues' analysis became reality—crippling Federal debt and skyrocketing interest rates—how would that impact the real estate industry?

Answer. Senator, fiscal discipline in Washington is important to long-term economic growth and prosperity. Policies that temporarily increase the Federal deficit can serve an important purpose during periods of economic distress, but policies—tax or spending—that contribute to structural budget imbalances are fraught with risk. At the same time, revenue neutrality should not be an end in itself. Rather, in the context of tax reform, policymakers should carefully consider how proposed changes affect entrepreneurship, capital formation, and job creation, among other important factors. Tax policy should be stable, predictable, and permanent. In addition to the risks you have identified, if tax reform dramatically increases the Federal deficit, it is unlikely that the changes will be permanent, at least not in their current form.

Question. Mr. DeBoer, the House Republican tax plan proposes to eliminate the deduction for business interest expense. While large, publicly traded corporations may be able to access additional equity from the stock market in order to dodge this new tax, that's not a choice for a lot of smaller businesses. Normally small businesses depend solely on small business loans from local banks. In addition, some businesses—particularly those that invest in real estate and infrastructure—depend on bonds as a way to finance long-term projects. I know your organization has been paying close attention to this issue. What do you think would happen if Congress voted to deny companies the ability to deduct interest?

Answer. Today, capital markets in the United States are the envy of the world. Entrepreneurs are able to access debt amounts needed to provide the flexibility to build, operate, and grow their business. Responsible, appropriate leverage, as determined by lending regulators, is very positive for economic growth and job creation. Eliminating, or even limiting, the deduction for interest on business debt would cause great dislocation, slow economic activity, and lessen the unique importance of America's capital markets. The cost of debt is a necessary expense that must be accounted for in order to accurately measure the income from any business activity.

Question. Mr. DeBoer, you've spoken about the need for infrastructure development. I've long said America needs an all-of-the-above approach to infrastructure. The number one priority is more funding, and I, and several of my Democratic colleagues, have put forward a plan to do that. But this is a crisis that requires all hands on deck. That's why I have a bipartisan proposal, with Senator Hoeven of North Dakota, to give States more flexibility in how they finance infrastructure, including allowing them to tap the private sector. Private activity bonds are one key tool that local governments have to develop infrastructure projects in partnership with the private sector. Some Republicans want to eliminate these tools. Wouldn't it be better if Congress were providing more pathways for infrastructure investment, not eliminating an effective tool for financing infrastructure?

Answer. The Roundtable agrees that an all-of-the-above approach to infrastructure finance is critical to meet our country's rapidly expanding and evolving needs for safe and reliable infrastructure across all types of asset classes—roads, bridges, transit, water, sewer, energy, telecommunications, etc. Public investment in infrastructure will always be critical, but receipts from the Federal gas tax are insufficient. As cars become more fuel efficient, and as the Nation is on the cusp of a "transportation revolution" trending toward driverless vehicles and ride-sharing platforms, more financing and funding sources are necessary beyond the Highway Trust Fund, which is perpetually on the brink of insolvency.

We thus agree that Congress should enact policies that attract more private-sector co-investment to partner with public funds to finance infrastructure. Legislation like Senator Wyden's and Senator Hoeven's Move America Act (S. 1229) which expands eligibility for tax-exempt private activity bonds, should be part of the finance "toolbox" to encourage private entities to invest in U.S. infrastructure. The Roundtable also recommends that Federal policies should encourage "best financing practices" that layer and sequence successful Federal programs with common State/local infrastructure finance platforms that have a track record of success. For example, projects that use Federal credit support and enhancement (like U.S.–DOT loans and guarantees under the Transportation Infrastructure Finance Innovation Act (TIFIA), and Railroad Rehabilitation and Improvement Financing (RRIF), should be encouraged to complement and leverage State/local infrastructure finance techniques (like tax increment finance (TIF) and special assessment districts (SADs)). Projects drawing a TIF–TIFIA connection, for example, can spread financing risks that will be attractive to draw private debt and equity markets into infrastructure projects, so that no single capital source bears undue risks. The Roundtable believes that these types of policies—bringing Federal, State/local, and private sector dollars to the table—are necessary to build the infrastructure we need to get people to work, enhance worker productivity, boost GDP, and enhance America's competitiveness globally.

QUESTION SUBMITTED BY HON. MICHAEL B. ENZI

Question. Mr. DeBoer, your testimony mentions the tax rules related to foreign investment in U.S. real estate and how they can inhibit domestic investment and job creation. In 2015, I was a cosponsor of a bill that eliminated some of the burden associated with the Foreign Investment in Real Property Tax Act (FIRPTA). Have you seen an impact from the reforms we made in the PATH Act? What has it meant for real estate and infrastructure investment and job growth? Should we be going further, and if so, what do you recommend?

Answer. Senator Enzi, The PATH Act reforms, including the new exemption from FIRPTA for foreign pension funds, have removed tax barriers to investment in the United States and allowed new real estate construction and development to attract foreign capital. Foreign institutional investors, and in particular pension funds, are a large and growing source of equity for capital-intensive real estate and infrastructure projects. Many foreign economies have high savings rates, and managers of those savings are looking to diversify their investments. Some foreign economies lack mature financial markets and offer few safe investment opportunities of their own. Pension funds are attracted to U.S. commercial real estate and infrastructure, in part, because it diversifies their investment portfolios, generates stable returns, and provides a hedge against inflation. After passage of the PATH Act, initial projections from Professor Ken Rosen of the University of California-Berkeley suggested it would generate $20–30 billion in additional inbound investment. While it is still early and quantitative data is just starting to come in, anecdotal reports suggest foreign pension funds are responding to the FIRPTA relief, qualifying for the provision, and actively investing in new U.S. markets.

The United States is well-positioned to attract foreign investors, assuming it provides a fair and nondiscriminatory set of tax rules. Real estate brokerage firm Cushman and Wakefield estimates that $435 billion of total debt and equity funds were available globally for direct real estate investment in 2017, an increase of $100 billion since 2013. Unfortunately, for many non-pension investors, FIRPTA continues to impose a discriminatory tax on passive investment in U.S. real estate that does not apply to other asset classes. FIRPTA should be repealed in its entirety. Professor Rosen estimates that repealing FIRPTA will generate $65–125 billion in additional U.S. economic activity, create 147,000–284,000 jobs, and lift income by $8–16 billion. Repeal would spur demand for real estate-related services, property renovations and development, and lending activities. Perhaps most importantly, it will create new economic demand that increases income and wages.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. What metric or considerations should Congress use to determine which tax breaks to eliminate in order to lower the rates?

Answer. Senator, we believe four principles should guide and inform your efforts to achieve a significant, pro-growth overhaul of the Nation's tax code. First, tax reform should encourage capital formation (from domestic and foreign sources) and appropriate risk-taking, while also providing stable, predictable, and permanent rules conducive to long-term investment. Second, tax reform should ensure that tax rules closely reflect the economics of the underlying transaction—avoiding either excessive marketplace incentives or disincentives that can distort the flow of capital investment. Third, tax reform should recognize that, in limited and narrow situations (*e.g.,* low-income housing and investment in economically challenged areas), tax incentives are needed to address market failures and encourage capital to flow toward socially desirable projects. Finally, tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets. Tax reform that adheres to these principles will spur economic growth and job creation.

Question. If you were king for a day, which tax breaks would you eliminate first to pay for a lower rate?

Answer. A good place to start would be eliminating negative tax expenditures from the tax code. Negative tax expenditures deviate from an otherwise neutral income tax system and penalize specific types of business activities or investments. The largest negative tax expenditure in the tax code is the 39-year depreciation schedule for nonresidential structures. According to the Treasury Department, this tax penalty will cost taxpayers $105 billion over the next 10 years. Cost recovery rules should align with the economic life of assets. Leading, peer-reviewed research by MIT on the economic depreciation of structures suggests the appropriate recovery period for both nonresidential and residential rental property is closer to 20 years. Shortening the depreciation period for real property to 20 years would provide a sustainable boost to real estate investment and job creation.

Second, policymakers should repeal the Foreign Investment in Real Property Tax Act (FIRPTA), which imposes a discriminatory tax penalty on foreign investment in U.S. commercial real estate. Professor Ken Rosen at the University of California-Berkeley estimates that repealing FIRPTA would generate $65–125 billion in additional economic activity and create 147,000–284,000 jobs.

Question. Could immediate expensing lead to any negative consequences for the economy? If so, please provide some potential scenarios. If not, please explain why.

Answer. Senator, expensing structures would encourage real estate development and boost the Nation's GDP, but we are concerned that underlying demand would not support much of the resulting development. Such uneconomic development would be a false indicator of economic strength and badly distort markets. As we witnessed in the 1980s, encouraging uneconomic development is not sustainable policy over the long term. That is not to say that the current cost recovery periods for structures are correct. They are not, and they should be shortened. MIT has reviewed a wealth of date regarding buildings, and their work suggests the appropriate depreciation period is roughly 20 years. Revising the tax rules to reflect this new and improved understanding of the economic life of structures would provide meaningful and sustainable lift to investment and job creation.

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 reforming the business tax code. The goal of the hearing is to examine ways to create a healthier economic environment that will encourage job creators to invest in the United States and increase their competitiveness in the global market.

During this morning's hearing, we will discuss ways to improve the business provisions of the U.S. tax code, with an eye toward creating jobs and boosting wages for American workers and improving our country's overall business climate.

This hearing is part of our ongoing effort—following years of tax hearings and last week's hearing on individual reform—to draft and report comprehensive tax reform legislation later this year.

Members of both parties recognize the need to reform the way we tax businesses in the United States. As former President Obama noted when discussing his own framework for business tax reform, the current system "does too little to encourage job creation and investment in the United States while allowing firms to benefit from incentives to locate production and shift profits overseas."

As we all know, many elements of a particular business's tax burden depend on the company's organizational form. For example, C corporations are taxed at the corporate tax rate.

According to a recent report by the Congressional Budget Office, the top Federal statutory corporate income tax rate has been 35 percent since 1993 and, with State taxes added, the United States' average corporate statutory rate is the highest in the industrialized world, at more than 39.1 percent.

And, while some have noted that not all corporations pay the full statutory rate, the average effective tax rate of U.S. corporations is the fourth highest among G20 countries. According to a recent analysis by Ernst and Young, when you integrate corporate-level taxes and investor-level taxes such as those on dividends and capital gains, U.S. tax rates are the second highest among developed countries. That last one is important, given that the United States taxes most corporate earnings that are distributed to shareholders twice—both at the corporate and shareholder levels.

For the past few years, I have been working on a corporate integration proposal that, among other things, would allow businesses to deduct their dividends paid to help alleviate the double taxation problem. I view this as a complement to a statutory corporate tax rate reduction, not a substitute. We held a few hearings on this topic last year, so I won't delve too deeply into the details at this time. For now, I'll just say I continue to believe this idea—whether it applies fully or in some other limited way—can help address a number of the problems we're trying to solve with comprehensive tax reform. I look forward to continuing this conversation as the process moves forward.

It is also important to note that, while the U.S. corporate tax rate has remained unchanged for decades, the trend among our foreign competitors has been to lower corporate rates, making American businesses increasingly less competitive.

This is not just a Republican talking point. This problem is widely acknowledged on both sides of the aisle. Even former President Bill Clinton, who signed into law the rate increase to 35 percent, recently argued the rate should now be lowered. I agree.

Our current business tax system—and the disparity between the U.S. corporate rate and our foreign competitors' corporate rates—has created a number of problems and distortions.

For example, the current system slows economic growth by impeding capital formation, hindering wage growth and job creation, reducing productive capacity, and lowering the standard of living in the United States, all of which directly harm middle-class families and individuals.

The current system lowers returns on investment, creating a bias against savings and investment. This hinders the creation of wealth for Americans across the economic spectrum, including the middle class.

The current system encourages corporations to finance operations using debt rather than equity, which increases risks, particularly during times of economic weakness.

The current system gives corporations incentives to shift income, production, and intangible assets like intellectual property from the United States to lower tax foreign jurisdictions, thereby eroding our tax base.

In tax reform, we need to address all of these problems and distortions, and many others as well. In particular, we need to lower the corporate tax rate to relieve the burdens the tax imposes on American workers, who, according to many economists, bear a significant part of the corporate tax.

We also need to reduce the burden on pass-through businesses, whose earnings are reported and taxed on individual tax returns. These types of businesses include sole proprietorships, limited liability companies, partnerships, and S corporations.

And, we need to fix our international tax system so that American businesses can compete in the global marketplace without facing significant disadvantages simply because they are headquartered in the United States.

Each of these propositions is supported by people in both parties. Of course, when politics enter the equation, the story sounds much different.

According to some, all Republicans want to do in tax reform is give tax breaks to the super-rich, cushy portfolios for Wall Street bankers, and more handouts for greedy corporations, all at the expense of middle-class workers and families.

Those types of claims may play well to political bases, but they don't align with reality.

As I noted in our hearing last week, virtually all of our current tax reform ideas are aimed squarely at helping the middle class as well as low-income families. Our chief goals, particularly in business tax reform, are to increase economic growth, create new jobs, grow wages for the employees of both large and small businesses, expand opportunities for all Americans, and improve standards of living for everyone in the United States.

The proof, I suppose, will be in the pudding. As the committee works through this process, with those goals in mind, I believe we will be able to demonstrate why those in the middle class should feel as though they have a stake in this discussion and how these ideas to reform our current system will help.

Let's keep in mind that the status quo—sluggish economic growth, stagnant wages, and decreased workforce participation—hasn't exactly been doing the middle class any favors. The case for tax reform should therefore be easy to make.

I want to reiterate what I said last week: namely, that this committee will be the starting point for any tax reform legislation that is considered in the Senate. While I expect we'll continue to hear more arguments about secret tax plans written behind closed doors, this committee is going to consider tax reform through regular order. That applies to both the drafting and the reporting of any tax reform bills.

As I also said last week, I hope this process is bipartisan. As with individual tax reform, there are many areas of business tax reform where thoughts and interests of both Republicans and Democrats overlap. There is fertile ground for bipartisan agreement on this and I hope we can take advantage of this historic opportunity together.

I know that my friend, Ranking Member Wyden, shares these broad objectives.

In fact, he has put forward his own tax reform proposals in the past, likely with these same goals in mind.

And, at the end of the day, we should all, at the very least, agree that the current tax system is broken and the current state of our economy should not be accepted as the new normal.

I look forward to a robust discussion of these issues here today as well as some acknowledgement of the bipartisan agreement that exists on these matters.

PREPARED STATEMENT OF SCOTT A. HODGE, PRESIDENT, TAX FOUNDATION

Chairman Hatch, Ranking Member Wyden, members of the committee, I commend you for taking on the challenge of reforming America's tax code and especially the task of overhauling our outdated business tax system.

The most important thing that Congress and the administration can do to boost economic growth, lift workers' wages, create jobs, and make the U.S. economy more competitive globally, is reform our business tax system.

I'd like to focus my remarks on reforming the corporate tax system. The tax issues facing pass-through businesses could fill an entire hearing itself. The Tax Foundation generally supports the idea of corporate integration, so perhaps we can address the pass-through sector during questions.

My testimony will first outline the policies that our research indicates will maximize economic growth and boost wages, what we call "The Four Pillars of Corporate Tax Reform." I will then address the challenges that you will face in crafting a successful tax reform plan—balancing the math with the economics.

THE FOUR PILLARS OF CORPORATE TAX REFORM

The Tax Foundation's extensive economic research and tax modeling experience suggests that the committee should have four priorities in mind when reforming the corporate tax system:

1. Providing full expensing for capital investments;
2. Cutting the corporate tax rate to a globally competitive level, such as 20 percent;
3. Moving to a competitive territorial tax system; and
4. Making all three of these policies permanent.

While many of you, and certainly many in the business community, may see some of these policies as competing for space in a tax plan, we see those pieces as complementary and essential, not in conflict.

In our view, cutting the corporate tax rate and moving to a territorial system are essential for restoring U.S. competitiveness and reducing the incentive for profit-shifting and corporate inversions. Expensing, we believe, is key to reducing the cost of capital in order to revitalize U.S. capital investment which, in turn, will boost productivity and wages.

Thus, a good tax plan should include all three of these policies because they will not only boost economic growth, but do so in a way that leads to higher wages and living standards for working Americans. However, these gains are not possible if the policies are made temporary, as some have suggested as a way of minimizing their revenue loss or complying with the Byrd Rule. Temporary tax cuts deliver temporary economic results; permanent tax reform delivers permanent economic benefits.

THE ECONOMIC BENEFITS OF EXPENSING AND A CORPORATE RATE CUT

Let's look at the economics of expensing and the corporate rate cut in more detail. Both policies are very pro-growth and will ultimately lift workers' wages. But, on a dollar-for-dollar basis, expensing delivers twice the economic growth as a corporate rate cut.[1]

The reason it does so is because expensing of new investment is focused on cutting the cost of growing the capital stock, while the rate reduction's benefits are spread over returns to existing capital and to other activities such as research, management, advertising, and other inputs that are already immediately deductible.

For example, if I own a factory that makes appliances, a lower corporate rate will increase the amount of after-tax profit I earn on each toaster, but it will not necessarily incentivize me to produce more toasters. On the other hand, the only way that I can reap the benefits of full expensing is by adding a new toaster assembly line or building a factory. Thus, the corporate rate cut initially flows to my bottom line, whereas the new capital investment immediately benefits my workers and new employees.

[1] For an excellent discussion of this issue, *see* Kyle Pomerleau, "Why Full Expensing Encourages More Investment Than a Corporate Rate Cut," Tax Foundation Blog, May 3, 2017, *https://taxfoundation.org/full-expensing-corporate-rate-investment/*.

THE COMBINED BENEFITS OF EXPENSING AND A CORPORATE RATE CUT

The House GOP "Better Way" Tax Reform Blueprint combined expensing with a 20 percent corporate rate. Our scoring of the plan indicated that these policies created a powerful engine for economic growth and lifting after-tax incomes.[2] They should provide the core of any pro-growth tax reform plan.

We used our Taxes and Growth (TAG) Macroeconomic Tax Model[3] to simulate the long-term economic effects of these policies separately and combined to give you an idea of how they work together. The table below summarizes the long-term results of this exercise.

Here we can see that cutting the corporate tax rate to 20 percent and moving to full expensing for corporations each boost the long-term level of GDP by 3 percent and increase the capital stock by more than 8 percent. This has the effect of lifting wages by more than 2.5 percent and creating more than 575,000 full-time equivalent jobs. In this example, long term is generally about 10 years, once the policies have worked their way through the economy.[4]

Combining the two policies does not double the results because of their interactive effects. However, we can see that the two policies together would increase the level of GDP by 4.5 percent and the capital stock by nearly 13 percent. These economic forces act to lift wages by an average of 3.8 percent and create 861,000 full-time equivalent jobs.

Long-Term Economic Effects of Expensing and a 20% Corporate Tax Rate

	20% Corporate Tax Rate	Corporate Only Full Expensing	20% Rate and Full Expensing Combined
GDP, long-run change in annual level (percent)	3.1%	3.0%	4.5%
GDP, long-run change in annual level (billions of 2016 $)	$587	$571	$867
Private business stocks (equipment, structures, etc.)	8.5%	8.3%	12.8%
Wage rate	2.6%	2.5%	3.8%
Full-time equivalent jobs (in thousands)	592	575	861

Tax Foundation, Taxes and Growth Model.

BOTH POLICIES BOOST AFTER-TAX INCOMES SUBSTANTIALLY

There is typically little public support for corporate tax reform because most people don't see how it will benefit their lives. Corporate tax reform may not "put cash in people's pockets" in the same way as a cut in individual tax rates, but it can have a powerful effect on lifting after-tax incomes and living standards.

As we saw in the modeling results above, both expensing and a corporate rate cut can boost wages because of the increased productivity generated by the growth in capital investment. Better tools make workers more productive. Workers who are more productive earn more over time. When these gains are combined with the overall growth in the economy, after-tax incomes and living standards will rise.

Tax Foundation's TAG model factors these macroeconomic effects into our estimates of the change in after-tax incomes for taxpayers at different income levels. The table below shows that a 20 percent corporate tax rate would lift after-tax incomes by an average of 3.5 percent. Expensing lifts after-tax incomes by 3.4 percent. The TAG model estimates that the combination of the 20 percent corporate tax rate and full expensing would boost after-tax incomes by an average of 5.2 percent. Again, these gains represent the combination of wage growth, economic growth, and the distributed dollar value of the tax cuts.

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[2] Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation Fiscal Fact No. 516, July 5, 2016.

[3] For a full description of the TAG model, *see https://taxfoundation.org/federal-tax/taxes-and-growth-model-overview-methodology/*. We are also happy to give live demonstrations of the model upon request.

[4] Over the long term, a 20-percent corporate rate is a bigger tax cut than expensing. That is why we are seeing comparable results from the policies.

Long-Term Policy Effects on After-Tax Incomes

Income Group	20% Corporate Tax Rate	Corporate Only Full Expensing	20% Rate and Full Expensing Combined
0% to 20%	3.5%	3.4%	5.2%
20% to 40%	3.3%	3.2%	4.8%
40% to 60%	3.4%	3.3%	5.0%
60% to 80%	3.4%	3.3%	5.0%
80% to 100%	3.6%	3.5%	5.3%
80% to 90%	3.4%	3.3%	5.1%
90% to 95%	3.5%	3.4%	5.2%
95% to 99%	3.6%	3.5%	5.4%
99% to 100%	3.7%	3.6%	5.5%
Total	3.5%	3.4%	5.2%

Tax Foundation, Taxes and Growth Model.

CUTTING THE CORPORATE TAX RATE WILL IMMEDIATELY IMPROVE U.S. COMPETITIVENESS

It is well-known that the 35-percent U.S. Federal corporate tax rate is the highest among the 35 member nations in the OECD. However, U.S. firms also pay State income taxes. When the average State rate is added to the Federal rate, American companies face an average U.S. rate of 38.91 percent tax on corporate earnings.

In a recent study, Tax Foundation economists compared the corporate tax rates levied by 202 jurisdictions across the globe and found that the United States has the fourth highest statutory corporate income tax rate in the world.[5] The only jurisdictions with a higher statutory rate are the U.S. territory Puerto Rico (with a population of 3.7 million), the United Arab Emirates (population 9.4 million), and the tiny African island nation of Comoros (population 826,000).

From a tax perspective, most other countries look much more competitive than the United States. The worldwide average statutory corporate income tax rate, measured across 202 tax jurisdictions, is 22.96 percent. When weighted by GDP, the average statutory rate is 29.41 percent—10 points lower than the U.S. statutory rate.

Our major trading partners in Europe have the lowest regional average rate, at 18.35 percent (25.58 percent when weighted by GDP). Conversely, among our major trading partners, Africa and South America tie for the highest regional average statutory rate at 28.73 percent (28.2 percent weighted by GDP for Africa, 32.98 percent weighted by GDP for South America).

While we frequently hear the excuse that "nobody really pays the headline rate" because of loopholes in the tax code, the fact is, the tax codes in other countries also have loopholes. This means that the effective corporate tax rate in those countries is typically well below our effective rate.

Indeed, a recent Tax Foundation study compared the tax burden on new investment, the marginal effective tax rate (METR), among 43 nations. After accounting for all the various deductions and credits in each tax code, the study finds that the METR in the United States is the fifth highest among the 43 nations at 34.8 percent.[6] Were it not for bonus depreciation, our ranking would be even higher.

Lowering the corporate tax rate to at least 20 percent would instantly make the U.S. more competitive while reducing the incentives for profit-shifting and inversions.

MOVING TO A TERRITORIAL TAX SYSTEM IS IMPERATIVE

One of the most challenging issues facing lawmakers is over the international aspects of tax reform: designing a territorial tax system and crafting the rules that determine when the foreign income of U.S. multinationals will be taxed and when it will be exempt from U.S. tax.

[5] Kyle Pomerleau and Keri Jahnsen, "Corporate Income Tax Rate Around the World," Tax Foundation Fiscal Fact 559, September 7, 2017, *https://taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/*.

[6] Jack Mintz and Philip Bazel, "Competitiveness Impact of Tax Reform for the United States," Tax Foundation Fiscal Fact 546, April 20, 2017.

These rules are extremely complex, and the stakes are very high. Tax writers must design rules that protect the U.S. tax base and prevent tax avoidance, yet do so in a manner that is not burdensome and does not stifle capital flows and legitimate business transactions. The wrong choices could make U.S. firms even less competitive globally than they are today.[7]

The interesting aspect of this issue is that the U.S. already has a territorial tax system—but it only applies to foreign-owned companies. Foreign-owned companies only pay U.S. income taxes on their U.S. profits and, naturally, pay no U.S. tax on their foreign profits. This situation automatically makes U.S. firms less competitive in foreign markets. The only way to level the playing field is for lawmakers to repeal our worldwide tax system and move to a territorial system for all companies.

EXPENSING SAVES MORE THAN $23 BILLION IN COMPLIANCE COSTS

One last thing to consider about expensing. A move to full expensing accomplishes something that no rate cut can: it eliminates pages from the tax code, thus saving taxpayers time and money. American businesses today spend more than 448 million hours each year complying with the Byzantine depreciation and amortization schedules, at an estimated cost of over $23 billion annually. Moving to full expensing eliminates the need for these complicated schedules, thus saving businesses the $23 billion in compliances costs, which is an added benefit to the impact the policy has on boosting wages and economic growth.[8]

TEMPORARY TAX CUTS PRODUCE (NO SURPRISE) TEMPORARY ECONOMIC BENEFITS

Because of the procedural limitations associated with the Senate's Byrd Rule, some lawmakers have talked about the merits of a temporary tax cut plan, which would sunset after 10 years, much like the tax cuts enacted by President George W. Bush in 2001 and 2003.

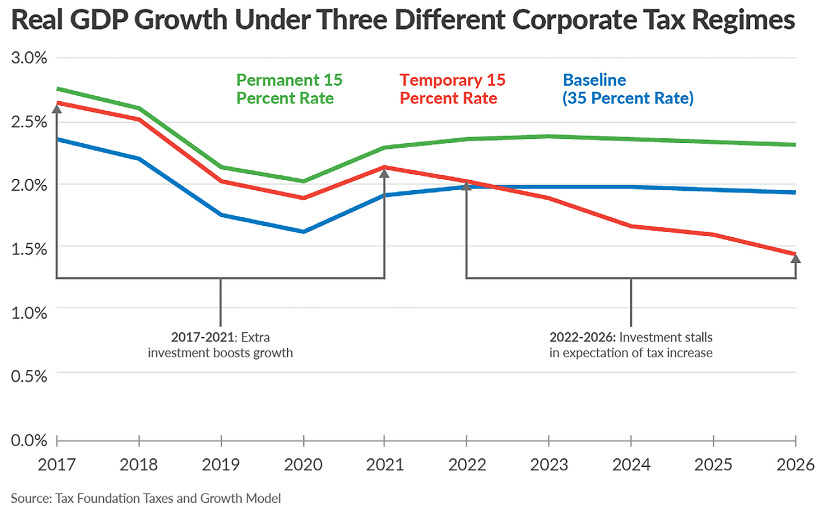
Tax Foundation economists used the TAG model to simulate the effects of a temporary corporate rate cut to 15 percent compared to the effects of a permanent rate cut, and the baseline estimates under current law. The results are shown in the nearby chart.[9]

A permanent corporate rate reduction reduces the cost of capital and makes new investments worthwhile that otherwise would not have been. Under the TAG model, a permanent cut to 15 percent boosts investment substantially, which allows a sustained period of higher growth. Such a policy adds about 0.39 percentage points to GDP growth per year over a decade, eventually resulting in a GDP that is 3.9 percent larger than the baseline scenario after 10 years. This additional 3.9 percent level adjustment to GDP remains for as long as the policy stays in effect; more investments are profitable, and therefore, the Nation is richer.

A temporary corporate rate reduction looks similar at first: it initially produces more investment and growth. However, the effect is never as strong as for the permanent cut. Worse, the improvements to growth fade considerably. The increase in GDP peaks in the 6th year, with a grand total of 1.37 percent added to GDP over all 6 years. Then, growth from the 7th year on is actually slower than it would have been with no tax cut at all. By the end of the 10th year and the sunset of the policy, GDP is only 0.14 percent larger than it would have been without the tax cut.

The lesson is very clear: the only way to boost the economy for the long term is to make the business tax reforms permanent.

[7] Kyle Pomerleau and Keri Jahnsen, "Designing a Territorial Tax System: A Review of OECD Systems," Tax Foundation Fiscal Fact No. 554, August 1, 2017.
[8] Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation Fiscal Fact No. 512, June 15, 2016.
[9] Alan Cole, "Why Temporary Corporate Income Tax Cuts Won't Generate Much Growth," Tax Foundation Fiscal Fact No. 549, June 2017.



THE CHALLENGES AND TRADE-OFFS OF BUSINESS TAX REFORM

The great economist Thomas Sowell once said that "there are no solutions, there are only trade-offs." As I'm sure you are already discovering, you will face some big challenges in fixing the corporate tax system. First, the math is hard. There are not as many "loopholes" in the corporate tax code as many people believe, so you will likely have to think outside the box if you want corporate tax reform to be revenue-neutral. Second, the economics of tax reform must be at the forefront of your decision-making. If you make the wrong choice in the base broadeners you use to offset the tax cuts, you can neutralize all the benefits you hope to achieve from the reforms. These challenges will require hard decisions and considerable trade-offs.

THE MATH IS HARD

Cutting the corporate tax rate to 20 percent and providing full expensing could reduce Federal revenues by as much as $3 trillion over 10 years on a static basis. While our models show that the growth effects of the policies could recover as much as 46 percent of this revenue loss over a decade (and more beyond the budget window), finding the revenue offsets to make these policies revenue neutral will be a major challenge.

For example, if your goal is to eliminate corporate tax expenditures to offset a rate cut, your options are limited. By our estimates, there are only enough "loopholes," or nonstructural items, to eliminate in the corporate tax code to bring the rate down to about 28.5 percent.[10] If the consensus is to lower the rate to 20 percent, or even 15 percent as President Trump advocates, you will have to find offsets outside the corporate tax base.

One of the larger offsets included in the House GOP Blueprint was the elimination of the net interest deduction for corporations. This policy has the advantage of raising more than $1 trillion with minimal impact on economic growth. Moreover, it also equalizes the treatment of debt and equity financing, thus reducing the amount of leveraging in the economy.

Aside from the elimination of net interest and the controversial border adjustment proposal, there are very few politically palatable revenue raisers or base broadeners available that can be used to help reduce the corporate tax rate to 20 percent or below. A few of the options that could raise more than $1 trillion over 10 years in-

[10] Scott Greenberg, "To Lower the Corporate Tax Rate, Lawmakers Will Have to Think Outside the Box," Tax Foundation Blog, June 8, 2017, *https://taxfoundation.org/lower-corporate-tax-rate-think-outside-box/*.

clude a $20 per-ton carbon tax, removing the Social Security Payroll tax cap, and enacting a value-added tax (VAT).[11]

On the other hand, there are ways of reducing the cost of these proposals by either phasing them in or modifying them. For example, the cost of full expensing could be reduced substantially through the use of neutral cost recovery. This option maintains current depreciation schedules, but indexes them for inflation and a modest rate of return. This modification gives taxpayers the net present value equivalent of full expensing, but spreads the budgetary costs over time.

Congress could also follow the example of other countries, such as Canada and the United Kingdom, who ratcheted down their corporate tax rate over a number of years. This option would reduce the cost of the policy within the 10-year budget window, but not during the second 10 years.

GETTING THE ECONOMICS RIGHT

In order to maximize the benefits of corporate tax reform, you must be very careful in choosing the offsets you need to make the plan revenue-neutral. You must avoid base broadeners that raise the cost of capital because they will neutralize the benefits of the pro-growth tax reforms.

A good example of how the wrong mix of policies can neutralize a plan's economic growth potential is the draft tax reform plan proposed by former Ways and Means Chairman Dave Camp. The so-called Camp Draft cut the corporate tax rate to 25 percent, but largely offset the revenue loss by lengthening depreciation lives—moving from the current MACRS to ADS, the alternative depreciation system.

As the tax models used by the Joint Committee on Taxation and the Tax Foundation showed, the longer depreciation lives raised the cost of capital to such an extent that it largely negated the economic benefits of the lower corporate tax rate.[12] Revenue neutrality may be an important goal, but it should not be achieved at the expense of economic growth. That is self-defeating. To fully reach the goal of a lower corporate tax rate, you may have to relax the standard for revenue neutrality.

One of the reasons that the House GOP "Better Way" Tax Reform Blueprint contained the controversial border adjustment was the recognition by its designers of the need to reach outside the traditional corporate tax expenditure base to find the necessary revenues to lower the corporate tax rate to 20 percent. The border adjustment also had a minimal impact on economic growth. Thus it raised more than $1 trillion over a decade in offsetting revenues while maximizing the economic benefits of the lower corporate tax rate and full expensing proposals.

CONCLUSION

Mr. Chairman, corporate tax reform done right is key to growing the economy, boosting real family incomes, and making the United States a better place to do business in, and do business from. The Four Pillars of Corporate Tax Reform—full expensing, a lower corporate tax rate, a territorial system, and permanence—are the right policies to make this tax reform effort a lasting success.

Thank you. I'm happy to answer any questions you may have.

Questions Submitted for the Record to Scott A. Hodge

Questions Submitted by Hon. Orrin G. Hatch

Question. Mr. Hodge, I appreciate that your testimony recognizes the difficult exercise that Congress has in front of it to make the tough choices and make the numbers work for comprehensive tax reform. You suggest that Congress, as part of comprehensive tax reform, provide for full expensing, and you identified in your testimony a potential method for reducing the cost of moving the tax system to such a proposal through indexing for inflation the current depreciation schedules and providing an appropriate rate of return. Would you elaborate more on your proposal and provide us a practical example of how it might work?

[11] For a menu of options, *see* "Options for Reforming America's Tax Code," Tax Foundation, 2016, *https://taxfoundation.org/options-reforming-americas-tax-code/*.

[12] Stephen J. Entin, Michael Schuyler, and William McBride, "An Economic Analysis of the Camp Tax Reform Discussion Draft," Tax Foundation Special Report No. 219, May 14, 2014.

Answer. As my colleague Kyle Pomerleau wrote in a recent Tax Foundation study, "How to Reduce the Up-Front Cost of Full Expensing," *https://taxfoundation.org/reduce-front-cost-full-expensing/*, "One way to reduce the cost of full expensing during the transition is to enact something called 'neutral cost recovery' (NCR). Under NCR, companies would get the benefit of full expensing: deductions for capital investments would get the full present value write-offs and bring the marginal tax rate on those assets down to zero, but the government would not suffer large transitional costs. This is how it would work: instead of providing a full write-off for capital costs, the Federal Government would keep the current law's depreciation schedule. However, depreciation allowances would be adjusted to an interest rate to offset both the effect of inflation and the time value of money." You can think of this as simply an enhanced indexing of depreciation schedules, not all that different than the way individual tax brackets are index to inflation.

Under NCR, a company still needs to depreciate assets over time according to a schedule. However, annual deductions are adjusted by an interest rate to offset the declining value of deductions over time. In the first year, a $100 deduction is the same as it is under current law. But as time goes on, the deductions grow in nominal terms. The second year, the company deducts $104 and the next year $108. These larger annual deductions end up offsetting the impact of the declining value of money over time. Thus, the present value of the deduction remains constant.

Question. Mr. Hodge, your written statement makes the case for permanent tax reforms as opposed to temporary tax reforms. So permanent is better than temporary. Is temporary better than nothing at all? You've noted the fact that the math is hard in comprehensive tax reform and complying with the Byrd rule in the Senate potentially provides boundaries on what can be done. Is comprehensive tax reform an all or nothing proposition, or would you recommend that Congress, if necessary, carefully identify those items that might be permanent and those that might be temporary in tax reform? What should Congress take into consideration in such an analysis?

Answer. The decision to make a policy temporary or permanent should depend on: (1) its impact on economic growth; (2) how much it effects behavior and decision making; and (3) how much the temporary policy would draw activity from the future to the present. If you are looking to make any of the tax cuts temporary, I would restrict that to the individual tax provisions. As we saw with the Bush tax cuts of 2003, salaried workers can't generally shift income from the future to the present, so little of the growth effect was lost on the temporary nature of the policy.

Corporate changes are different. Because corporations plan for the long-term, they need more stability in the tax code. They are also more adept at shifting activity from the future to the present. That is why temporary expensing may give you some economic growth today, but as the expense of lower economic growth tomorrow. Thus, the corporate tax provisions of any comprehensive package should be permanent.

Question. Mr. Hodge, the President and his administration have indicated on many occasions that one of their primary goals in comprehensive tax reform is to grow the economy. I think many, if not all, of us in this room share that view. Would you provide us your thoughts on why policies like full expensing and cutting corporate income tax rates lead to higher economic growth? How would you rank the tax policies that contribute most to economic growth, and why?

Answer. Dollar-for-dollar, tax changes that lower the cost of capital will do more for economic growth than any other policies you can enact. This is because capital is more mobile and, thus, more sensitive to tax changes than labor, which is less mobile. Cutting the cost of capital incentivizes new investment, which makes workers more productive, thus increasing their wages and living standards over time. Individual tax cuts may give people tax relief, but cutting the corporate tax rate and full expensing do more in the long run to boost wages and living standards. That should be the ultimate goal of any tax reform plan.

Question. Mr. Hodge, you state that expensing delivers twice the economic growth as a corporate rate cut. While you are certainly in favor of a corporate rate cut, you note that a rate reduction's benefits are spread over returns to existing capital. So, my question is, would a delayed, or phased-in, rate cut significantly lessen this windfall effect of giving benefits to existing capital?

Answer. Yes, every year following the first phase-in year would benefit new capital more than existing capital, thus diminishing the windfall for those old investments.

Question. Mr. Hodge, you state that permanent tax reform is much better than a temporary tax cut. I agree with you. But my question is: Would it be better to do nothing than to have a temporary tax cut?

Answer. Some temporary tax cuts can actually leave the economy worse off in the long run than doing nothing. For example, when we modeled the effects of a 5-year temporary expensing provision, we found that after 10 years GDP was only 0.18 percent higher than it would have been, but that the rate of growth was slower than trend. That is because the temporary policy pulled so much activity from the future to the present that it left the future with fewer resources.

Question. Mr. Hodge, in your written testimony, you cite favorably the House GOP Blueprint's proposal to eliminate the deduction for net interest expense for corporations. But can you help me understand, why is that elimination focused on net interest expense? Why net? If we think interest in some circumstances shouldn't be deductible, why wouldn't that be across the board, whether or not one had interest income?

Answer. Restricting the elimination of the interest deduction to net interest protects banks and lending institutions from the restriction. For them, borrowed money is their cost of goods sold and should be deductible. The idea is to restrict the deduction only to those who borrow as an end user.

Question. Mr. Hodge, you cite, in your written testimony, as an option for raising over a trillion dollars annually, the possibility of removing the Social Security Payroll tax cap. I didn't see your testimony as endorsing that idea, but I did want to ask you about it. Under current law, the benefits one receives from the Social Security program are tied, somewhat, to the payments one makes into the Social Security trust fund, via one's FICA or Social Security taxes. But if the Social Security Payroll tax cap were eliminated, wouldn't this make the connection between payments in and benefits out even more tenuous than is currently the case? I'd be concerned about the healthiness of the Social Security system, and for its broad support, if that were done.

Answer. Yes, if Congress were to lift the payroll tax cap while keeping the defined benefit, it would essentially have the same effect of funding Social Security out of general revenues, thus undermining the self-financing nature of the program. Social Security would then become no different than any other transfer program in government.

Question. Mr. Hodge, you noted that the OECD has said that the corporate tax is the least efficient tax. You noted that this is mostly because of the high mobility of the corporate tax base. What did the OECD say was the most efficient tax? Is the tax base of the most efficient tax highly mobile?

Answer. In their study, "Tax and Economic Growth" *(https://www.oecd.org/tax/tax-policy/41000592.pdf),* OECD economists set out to determine which taxes were most conducive to economic growth. Or, conversely, they wanted to create a hierarchy or rule of thumb for thinking of which taxes were most harmful to growth, so that government would shift the composition of their tax systems to one that did the least harm to their economies.

Here is that hierarchy:

- **Corporate** income taxes are most harmful for economic growth because capital is the most mobile factor in the economy.
- **Personal** income taxes are second-most harmful for growth. People are not as mobile as capital, but marginal tax rates influence their decisions to work, save, and invest.
- **Consumption** taxes are next-most harmful for growth. Taxes can influence decisions to consume, but the impact is less than taxes on income.
- **Property** taxes are least harmful for growth because property is the least mobile factor.

Question. Mr. Hodge, both you and Dr. Marron favor expensing, and both of you believe it should be a higher priority for Congress than a reduction of the corporate tax rate. I understand one of the main arguments for such prioritization is that a corporate tax rate cut, while incentivizing new investment is, in large part, a windfall to old capital. That is, a corporate rate cut gives a benefit to income that would have been generated anyway. Expensing, on the other hand, only gives a tax benefit to new investments, so wouldn't be granting windfall benefits. Am I stating that argument correctly?

Answer. Yes, that is a correct way of understanding the issue.

Question. But I also want to ask, couldn't expensing also result in a windfall benefit? That is, if a business was going to invest $100 million, say, in capital equipment under the Alternative Depreciation System (ADS), then to allow the $100 million to all be deducted in the first year of such investment, to allow it to be expensed, wouldn't that be giving a tax benefit for activity that would have happened anyway? Shouldn't that be considered a windfall benefit?

Answer. It is not a windfall, because allowing a business to immediately deduct their expenses—capital or otherwise—is the proper way to measure net business profits. When you force a business to write that capital expense over a long period of time, you are actually taxing them closer to gross revenues, not net profits. Thus, they are being over-taxed.

Question. Finally, would one way to address this problem be to allow full expensing for capital expensing that exceeds some base account, similar to how is done with the R&D credit. (With the R&D credit the point of that is that the R&D credit is targeted on research that would not have happened anyway, that would not have happened but for the credit.) Perhaps this could be a way to get most of the same growth effect from expensing, but while limiting the revenue costs.

Answer. No. Remember, the R&D credit is in addition to whatever deductions that companies get for their R&D expenses. Thus it is giving them an extra deduction for whatever activity they are engaged in. As I mention above, companies should be able to immediately expense their expenses of any kind because that is the correct way of calculating net profits.

Question. Some believe if tax reform loses revenue, the resulting deficits may crowd out private investment. Could you please explain that more?

Answer. We are very skeptical of this argument. In our review of recent economic history, there is little or no relationship between deficits and interest rates. If anything, the relationship has been negative—interest rates have fallen as the deficit increased. Our reading of recent empirical studies confirms this lack of relationship.

Congress is now considering a tax cut package in the range of $1.5 trillion over 10 years. The global credit market is simply too big for a tax cut that would add about $150 billion to the deficit annually to move global interest rates. Besides, our model suggests that the economic benefits of such a tax cut would more than outweigh any downsides if interest rates were to tick up a few basis points.

Question. You seem to think that a move towards expensing would be more helpful to the economy than would a corporate rate cut. But, I will tell you that from many corporations I hear from, they seem to prefer the corporate rate cut. Why do you think that is? How much of that has to do with financial accounting—and if so, how much should policymakers take that into account?

Answer. Accountants and economists see the world differently, and good tax policy should be driven by economics not by accounting. Corporate CFOs tend to care more about their financial statements than cash-flow or economic incentives. Expensing does not benefit their P&L in the same way as a corporate rate cut. Thus, they don't see the benefit of expensing. Besides, many of these companies are contracting out the manufacturing of their products to foreign firms, thus expensing does not improve the return from that relationship as does a rate cut. But one reason that so much U.S. manufacturing has moved offshore is because of how poorly we treat capital investment. Moving to full expensing would reverse that trend."

Question. If investment in capital assets were allowed to be expensed, should there be exceptions to this for LIFO? For land? For real estate improvements?

Answer. I tend to think that if we were to allow full expensing as a policy LIFO would be unnecessary because inventories would be expensed immediately. Same with real estate improvements, since they are a cost of doing business. Land generally does not depreciate (separate from the issue of minerals), thus it should not be expensed.

QUESTION SUBMITTED BY HON. MIKE CRAPO

Question. Mr. Hodge, when talking about comprehensive tax reform, I've often said that if one tried to create a tax code that was more unfair, more complex, more costly to comply with and more anti-competitive for American business, you couldn't do worse than the tax code we have now. One of the challenges is, then, if we are going to enact comprehensive tax reform that addresses each and every one of those problems with the current code, how can we actually measure our success in achieving all of those goals?

I know you all have done a lot of work there at the Tax Foundation. So I was interested in your views. At our hearing last week, one of the witnesses suggested that the Joint Tax Committee's conventional analysis on the changes in after-tax income would be the most appropriate way to measure the effects of reform. If we were talking about just a traditional run of the mill tax cut bill, then maybe you can argue that traditional JCT analysis would be sufficient.

But if we're going to completely reform the code in a way where we will be able to tell the typical American taxpayer that they no longer spend the hours every year saving their receipts and documenting their expenses and either doing their own taxes or spending hundreds of dollars to buy some software or pay someone else to do their taxes, that will be a real and meaningful benefit for them, but isn't necessarily going to be reflected in a typical JCT analysis.

The same thing goes for when we reform the business and international tax codes, which won't just help the bottom line of those American businesses, but will also create more job opportunities and higher wages for American workers.

Can you discuss any work you and the Tax Foundation have done, or any thoughts you have, about how we can best account for and then explain to the American taxpayer all of the benefits they will see from comprehensive tax reform, including those that are not reflected in a conventional JCT analysis, and those that are not necessarily so easily quantifiable?

Answer. The success or failure of tax cuts are typically marked by how they impact the last line on a taxpayer's 1040. But whether or not people save on their tax bills is only part of the story. It is almost more important to know how a tax plan will effect the economy, capital investment, wages, and after-tax incomes. After all, wouldn't it be terrible to enact a tax reform plan that gave people a tax cut today, only to so depress investment and economic growth that wages fell and jobs were lost?

Our Taxes and Growth (TAG) macroeconomic tax model takes all of those economic factors into account. Sure, the model can estimate how taxpayers' 1040s will be effected. But, the model also measures how a tax plan will impact their after-tax incomes once the economy finally adjusts to the tax changes. If their after-tax incomes go up, you know the plan was pro-growth. If their incomes go down, you know that some part of the tax plan undermined growth. That is the true value of dynamic scoring.

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. To the extent that the goal of the 1986 Act was to simplify the tax system, I suppose it could be considered a success. But if the goal was to promote economic growth, our modeling of the 1986 Act suggests that it was a failure.

My colleagues went back and modeled all the major tax bills over the past 50 years and found that the 1986 was actually bad for economic growth because it raised the cost of capital on businesses in order to provide tax cuts for individuals. Thus, we found that the albeit simpler post-1986 tax code slowed the economy.

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 think that tax reform and entitlement reform are each hard enough on their own that they should not be tried at the same time.

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 explain how through a detailed example (with budget estimates).

Answer. I guess it depends upon what you mean by significantly add to the deficit. When we model a cut in the corporate rate to 15 percent, we estimate that it would reduce Federal revenues by about $2.1 trillion over a decade on a static basis. After accounting for the growth effects from that lower rate, our model suggests that the cost of the rate cut would fall to about $1 trillion.

As for offsets, eliminating numerous deductions in the corporate code and eliminating interest deductibility would get you about half-way to revenue neutral. In order to get to full revenue neutrality, you'd have to look outside of the corporate code for offsets.

Question. What metric or considerations should Congress use to determine which tax breaks to eliminate in order to lower the rates?

Answer. Let economics be your guide. Start with the tax breaks that do most to distort the economy and those that inappropriately benefit certain industries at the expense of others. Then, you should ask, will repealing this provision do more economic harm than the benefits we expect to achieve from the tax provision it will offset? If so, then it is not a good tradeoff. If yes, then the tradeoff is worth it.

Question. If you were king for a day, which tax breaks would you eliminate first?

Answer. I'd start with the State and local tax deduction, followed by the exemption for credit unions, energy production credits, bio-diesel credits, tax credits for clean-fuel burning vehicles, section 199 manufacturing deduction, exclusion of interest for State and local bonds. Those are all good starts.

Question. Do your economic and revenue scoring models account for things like "Passive Loss" and "At-Risk" rules, which would prevent many real estate investors, including many small businesses, from being able to use immediate expensing?

Answer. No, our model doesn't account for that unless it is written into the policy that we are scoring. That is why lawmakers will have to take that into account by scaling up loss carryforwards. The House GOP Blueprint essentially indexed carryforwards to inflation plus a small rate of return in order to preserve the real value of the deduction.

Question. Do your economic and revenue scoring models factor in how an elimination or decrease in interest deductibility would impact small businesses, banks, and access to affordable capital?

Answer. Yes, our model takes into account the entire macroeconomic effect of the policy. When we scored the House GOP Blueprint, our model found that eliminating interest deductibility would only reduce the level of GDP by 0.4 percent over 10 years. That is a pretty small effect.

Prepared Statement of Troy K. Lewis, CPA, CGMA, Immediate Past Chair, Tax Executive Committee, American Institute of Certified Public Accountants

Introduction

Chairman Hatch, Ranking Member Wyden, and members of the Senate Committee on Finance, thank you for the opportunity to testify today on business tax reform. My name is Troy Lewis. I am an Associate Teaching Professor at Brigham Young University. I am also a sole tax practitioner and the Immediate Past Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to testify today on behalf of the AICPA.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on Federal, State, local and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

As the committee tackles this rare opportunity to enact bold, pro-growth business reform, we urge Congress to take a holistic approach to provide tax reform to all of America's businesses. Fair and equitable tax reform will drive economic growth and job creation, enhancing the competitiveness of all types of American businesses not only in the United States but also abroad.

The AICPA is a long-time advocate for an efficient and pro-growth tax system based on principles of good tax policy.[1] We need a tax system that is fair, stimulates economic growth, has minimal compliance costs, and allows taxpayers to understand their tax obligations. These features of a tax system are achievable if principles of good tax policy are considered in the design of the system.

AICPA PROPOSALS

In the interest of good tax policy and equitable and effective tax administration, we appreciate the opportunity to address the following issues:

1. Cash method of accounting.
2. Tax rates for pass-through entities.
3. Distinguishing compensation income.
4. Interest expense deduction.
5. Cost recovery.
6. Definition of compensation.
7. Alternative Minimum Tax repeal.
8. Mobile workforce.

1. Cash Method of Accounting

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting.[2] The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the related income. Therefore, entrepreneurs often choose this method for small businesses.

We are concerned with, and oppose, any new limitations on the use of the cash method for any business, including those businesses whose income is taxed directly on their owners' individual returns (such as partnerships and S corporations). Requiring businesses to switch to the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth.[3]

The AICPA believes that further restricting the use of the cash method of accounting for businesses would:

a. Discourage natural small business growth;
b. Impose an undue financial burden on their individual owners;
c. Increase the likelihood of borrowing;
d. Impose complexities and increase their compliance burden; and
e. Treat similarly situated taxpayers differently (merely because income is taxed directly on their owners' individual returns).

Congress should not further restrict the use of the long-standing cash method of accounting for the millions of U.S. businesses (*e.g.,* sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method.

2. Tax Rates for Pass-Through Entities

If Congress, through tax reform, lowers the income tax rates for C corporations, all types of business entities should receive a rate reduction. Our laws should continue to encourage, or more accurately—not discourage—the formation of pass-through entities as these business structures provide the flexibility and control desired by many owners that is not available within the more formal corporate structure. The vast majority of America's businesses are structured as pass-through entities (partnerships, S corporations, limited liability companies, or sole proprietorships).[4] Tax reform should not disadvantage these entities or require businesses to engage in complex entity changes to obtain favored tax status.

Tax reform should recognize the importance of consistent tax rates on business income generated from all of America's pass-through entities, including professional

[1] AICPA, "Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals," January 2017, *https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf.*

[2] AICPA letter, "Investment in New Ventures and Economic Success Today Act of 2017 (S. 1144)," June 22, 2017, *https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Letter-to-Senator-Thune-in-Support-of-the-INVEST-Act-S1144.pdf.*

[3] A required switch to the accrual method affects many small businesses in certain industries, including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

[4] *See* Census Bureau, "County Business Patterns," *https://www.census.gov/programs-surveys/cbp.html;* Census Bureau, "Nonemployer Statistics," *https://www.census.gov/programs-surveys/nonemployer-statistics.html.*

service firms. Inequities would arise from having significantly different income tax rates based on an overly simplistic approach such as one based solely on the structure, sector, or the general nature of a business' activities.

Professional service firms are an important sector in our economy and heavily contribute to the Nation's goals of creating jobs and better wages.[5] For example, according to the current employment statistics from the U.S. Bureau of Labor, the Accountants and Auditors service industry has a job growth outlook of 11% (as opposed to the average growth rate of 7% for all occupations) for the years 2014–2024.[6] Furthermore, the jobs created by professional service firms are driving a more educated workforce for delivery of advanced services and products. These jobs are often coveted due to higher wages as well as health care, retirement, and other benefits.

Excluding professional services reflects a view of the industry that may have applied in the 1950s, but certainly does not represent the current integrated global environment. In today's economy, professional service pass-throughs are increasingly competing on an international level with businesses organized as corporations, require a significant investment in tangible and intangible assets, and rely on the contribution of salaried, nonequity professionals to generate a significant portion of the revenue.[7] Artificially limiting the use of a lower business rate, regardless of industry, would penalize a business for operating as a pass-through entity.

All business owners have: uncertainty and risk to manage; increased administrative and reporting responsibilities at the State, local and/or Federal level; a potentially significant investment in assets;[8] and ultimately an obligation to their customers and employees. Without the benefit of a fair and consistent rate reduction for all pass-through entities, the incentive to start or grow a business is diminished, with a corresponding loss of jobs and reduction in wages.

3. Distinguishing Compensation Income

If Congress provides a reduced rate for active business income of sole proprietorships and pass-through entities, we recognize that it will place additional pressure on the distinction between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by codifying traditional definitions of "reasonable compensation" supplemented, if necessary, by additional guidance from the U.S. Department of the Treasury and the Internal Revenue Service.

The definition of reasonable compensation should reflect the type of business, the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles). Other relevant factors include available guidance (if any) used to help determine reasonable compensation for the geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics), and the book value and estimated fair market value of tangible and intangible assets that generate income for the business.

Former Ways and Means Committee Chairman Dave Camp's 2014 discussion draft[9] included a proposal to treat 70% of pass-through income of an owner-operator as employment income. While this proposal presented a simple method, it would result in an inequitable outcome in many situations. If Congress moves forward with

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[5] In 2014 (the latest data available), the U.S. professional services industry comprised about 883,000 firms and employed 8.6 million Americans. The industry achieved combined annual revenues of $1.6 trillion in 2015. *Selectusa.gov;* Professional Services Spotlight, *https://www.selectusa.gov/professional-services-industry-united-states.*

[6] Bureau of Labor Statistics website, Publications, Business and Financial, "Accountants and Auditors," *https://www.bls.gov/ooh/business-and-financial/accountants-and-auditors.htm.*

[7] The United States is the world's most desired location for professional services firms. In today's integrated global environment, businesses find it critical to access the talent, institutions, business processes, and client base offered in the United States; *Selectusa.gov;* Professional Services Spotlight, *https://www.selectusa.gov/professional-services-industry-united-states.*

[8] Although professional service firms are not as heavily invested in *tangible* assets as manufacturing firms, they generally have a substantial investment in *intangible* assets. For example, accounting, legal, engineering, computer consulting, and other professional service practices require continuing and substantial investment in software, hardware, assembling, and training a workforce, marketing, cybersecurity, office facilities, and malpractice insurance.

[9] H.R. 1 (113th Congress), The Tax Reform Act of 2014, *https://www.congress.gov/bill/113th-congress/house-bill/1,* section 1502; *also see* Section-by-Section Summary, pages 32–33, *https://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_by_Section_Summary_FINAL_022614.pdf.*

a 70/30 rule, or other percentage split, we recommend limiting it to active owners and making the proposal a safe harbor option. For example, the proposal must make clear that the existence and the amount of the safe harbor is not the required amount permitted but that the reasonable compensation standard utilized for corporations will remain available to taxpayers. These rules will provide a uniform treatment among closely held business entity types.

4. Interest Expense Deduction

Another important issue for small businesses, as well as for professional service firms, is the ability to deduct interest expense. New business owners incur interest on small business loans to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and to build credit for future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (such as to the extent of interest income) would effectively eliminate the benefit of a valid business expense deduction for many small businesses, as well as for many professional service firms. If a limit on the interest expense deduction is connected with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering larger manufacturers and retailers a greater tax benefit. As a result, business formations by small start-ups are hindered.

Currently, small businesses can expense up to $510,000 of depreciable acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal [10] under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment, and depreciable real estate, in the first year. However, since small businesses do not usually purchase large amounts of new assets, this proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only eliminates an important deduction for many businesses, which are forced to rely on debt financing to cover their operating and expansion costs.

At a minimum, we suggest allowing small (and perhaps “mid-size”) businesses to continue to deduct net interest expense.

5. Cost Recovery

In general, the AICPA supports cost recovery legislation, such as Senator Thune’s Investment in New Ventures and Economic Success Today Act of 2017, S. 1144, which would simplify, for businesses and their owners, certain accounting rules and key parts of the IRC.[11]

Many of the cost recovery provisions (such as, the expansion of the deduction for start-up and organizational expenses, the expensing of inventory by small and mid-sized businesses, and the exception for small and mid-sized businesses from capitalization of certain costs to inventory) would contribute to simplifying the tax rules and encourage economic growth and efficiency. We also appreciate that S. 144 updates the schedule of cost recovery periods for depreciable property under Revenue Procedure 87–56 to include a range of technology and other types of property that did not exist in 1987 would provide clarity, eliminate controversy, and provide a more accurate reflection of depreciation.

6. Definition of Compensation

Tax reform discussions have considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct.

We are concerned, particularly from a small business perspective, about any decrease of an employer’s ability to deduct compensation paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the tax code would substantially impact the small and labor-intensive businesses’ ability to build and retain a competitive workforce.

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[10] House Republican’s Tax Reform Task Force Blueprint, “A Better Way: Our Vision for a Confident America,” June 24, 2016, *https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.*

[11] AICPA letter, “Investment in New Ventures and Economic Success Today Act of 2017 (S. 1144),” June 22, 2017, *https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Letter-to-Senator-Thune-in-Support-of-the-INVEST-Act-S1144.pdf.*

7. Alternative Minimum Tax Repeal

The AICPA supports the repeal of the alternative minimum tax (AMT).[12] The current system's requirement for taxpayers to compute their income for purposes of both the regular income tax and the AMT is a significant area of complexity of the tax code requiring extra calculations and recordkeeping. The AMT also violates the transparency principle because it masks the amount a taxpayer can deduct or exclude, as well as the taxpayer's marginal tax rate. Small businesses, including those operating through pass-through entities and certain C corporations, are increasingly at risk of being subject to the AMT.

The AMT was created to ensure that all taxpayers pay at least a minimum amount of tax on their economic income. However, businesses suffer a heavy burden because they often do not know whether they are affected by the AMT until they file their Federal income tax returns. Therefore, they must constantly maintain a reserve for possible AMT, which takes away from resources they could allocate to business needs such as hiring, expanding, and giving raises to workers.

The AMT is a separate and distinct tax regime from the "regular" income tax. IRC sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions, and credits under the AMT system. This separate calculation is required for all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations. Businesses must maintain annual supplementary schedules, used to compute these necessary adjustments and preferences, for many years in order to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity affects the IRS's ability to meaningfully track compliance.

8. Mobile Workforce

The AICPA supports the Mobile Workforce State Income Tax Simplification Act of 2017, S. 540, which provides a uniform national standard for non-resident State income tax withholding and a *de minimis* exemption from the multi-state assessment of State non-resident income tax.[13]

The current situation of having to withhold and file many State nonresident tax returns for just a few days of work in various States is too complicated for both small businesses and their employees. Businesses, including small and family businesses that operate interstate, are subject to a multitude of burdensome, unnecessary and often bewildering non-resident State income tax withholding rules. These businesses struggle to understand and keep up with the variations from State to State. The issue of employer tracking and complying with all the different State and local tax laws is complicated and costly. The documentation takes extra time, adding to the loss in economic productivity for small businesses.

S. 540 would provide long-overdue relief to all businesses from the current web of inconsistent State income tax and withholding rules on nonresident employees. Therefore, we urge Congress to pass S. 540 that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

CONCLUDING REMARKS

The AICPA has consistently supported business tax reform efforts that are based on the principles of good tax policy, as we are convinced it will promote simplification, reduce business compliance costs and stimulate economic growth. As Congress drafts tax reform legislation, we encourage you to provide equality, certainty and

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[12] AICPA written testimony before the House Committee on Ways And Means, Subcommittee on Select Revenue Measures, March 3, 2011, "Hearing on Small Businesses and Tax Reform," *https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/FINALTESTIMONYFORTHOMPSONMarch32011.pdf*, and AICPA comments to the House Committee on Ways and Means on the Tax Reform Act of 2014, January 12, 2015, *https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf*.

[13] For additional details, *see* AICPA written statement, "AICPA Statement for the Record of the April 13, 2016 Hearing on 'Keep it Simple: Small Business Tax Simplification and Reform, Main Street Speaks,'" April 7, 2016, *https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/aicpa-comments-mobile-workforce-subcom-small-bus-hearing.pdf*.

clarity for all business owners. Businesses, regardless of entity structure, sector or the general nature of its activities, should similarly thrive under comprehensive tax reform.

The AICPA appreciates the opportunity to submit this testimony and we look forward to working with the committee as you continue to address business tax reform.

QUESTIONS SUBMITTED FOR THE RECORD TO TROY K. LEWIS

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

Question. I have heard from my colleagues across the aisle the parade of horribles that will ensue if Congress enacts a proposal to provide a lower business income tax rate for pass-through entities—that it will only benefit the rich and that it will, according to Dr. Marron, "inspire tax avoidance." And yet two of the witnesses came to the table with thoughtful approaches on how to address the concerns that compensation, or wage income, that is taxed at ordinary income tax rates will be inappropriately recharacterized as business income subject to a preferential business income tax rate. I'd like to have Mr. Lewis and Mr. DeBoer comment on their proposals, whether the concerns raised are legitimate but perhaps overblown, and provide their thoughts on administrative issues associated with their proposals.

Answer. Professional service providers face the same economic and legal challenges as other businesses. Any perceived tax savings of restructuring as an independent contractor, are unlikely to cover the incremental business cost of obtaining one's own employment benefits, losing unemployment coverage, providing for self-funded health care and incurring business-related costs (investment in technology, malpractice insurance, annual continuing education, office rental expense, etc.).

Furthermore, employers are bound by case law in determining employment status, which would prevent them from contracting with former employees who impulsively changed their status to independent contractor. If an employer claims independent contractor status for a worker without a reasonable basis, both the worker and employer are subject to penalties and taxes.

Question. Recently, Treasury Secretary Mnuchin commented on tax reform generally, and in particular on the potential for a lower rate for pass-through business income. He made a distinction between income that was generated from services businesses, which would be subject to ordinary income tax rates, and other income. Mr. Lewis, am I correct that your testimony suggests that not all returns in services businesses are returns on labor, so that some portion of the return should be subject to the pass-through business rate? Would you elaborate more on that point?

Answer. Yes, you are correct. A portion of pass-through income is business income (or a "return on capital") and a portion is compensation-related (or a "return on labor"). There is existing case law on the issue, and we recommend codifying the traditional definitions of "reasonable compensation" supplemented, if necessary, by additional guidance from the U.S. Department of the Treasury and the Internal Revenue Service.

The definition of reasonable compensation should reflect the type of business, the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as non-owner employees and capital invested). Other relevant factors include available guidance (if any) used to help determine reasonable compensation for the geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics), and the book value and estimated fair market value of tangible and intangible assets that generate income for the business.

Former Ways and Means Committee Chairman Dave Camp's 2014 discussion draft included a proposal to treat 70% of pass-through income of an owner-operator as employment income. While this proposal presented a simple method, it would result in an inequitable outcome in many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend limiting it to active owners and making the proposal a safe harbor option. The reduced rate should apply to owners who do not work in the business (*i.e.,* none of their income should qualify as employment income). Congress should also avail the reasonable compensation standard (currently utilized for corporations) to all taxpayers. These rules would provide uniform treatment among closely-held business entity types.

Question. Mr. Lewis, I understand some of your testimony to say that interest expense should remain deductible, but that some accelerated depreciation/expensing is a good thing. However, the House Blueprint saw those issues as tied together. That is, it connected the call for expensing with its elimination of net interest expense deductibility. Do you think those issues should not be seen as related to each other? Do you have a comment on the House Blueprint's elimination of net interest expense?

Answer. Interest expense and accelerated expensing are both important issues. I am not suggesting that you tie the issues together. However, if they are tied together, it is important to note that small businesses can currently expense up to $510,000 of depreciable acquisitions per year under section 179 and deduct all associated interest expense. Also, since small businesses do not usually purchase large amounts of new assets, the Blueprint's proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only eliminates an important deduction for many businesses, which are forced to rely on debt financing to cover their operating and expansion costs.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. I have a bipartisan bill with Senator Collins to make sure small business don't have to pay a higher tax on their business income than the largest corporations. The bill is called the Main Street Fairness Act (S. 707). Do you think a bill like ours would be a good place to start for tax reform?

Answer. The AICPA does not currently have a position on your and Senator Collins' Main Street Fairness Act.

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. It would take an extensive analysis, which I have not performed, to determine if the 1986 Tax Reform Act solved the problems it was intended to fix. My personal thought is that it likely solved some problems but not all of them. For example, the 1986 Tax Reform Act resolved the prevalence of abuse of tax shelters by creating a new section 469 of the Internal Revenue Code which prevented taxpayers from offsetting income with passive deductions and credits.

Question. Please provide suggestions on how Congress should determine which tax breaks to eliminate in order to pay for lower rates.

Answer. The AICPA does not have a position on which tax breaks to eliminate in order to pay for lower rates; however, we encourage a holistic approach, based on the principles of good tax policy, that is both equitable and meaningful to drive economic opportunities for individuals and families while leveling the playing field for American businesses not only in the United States but also abroad.

Question. If you were king for a day, which tax breaks would you eliminate first?

Answer. The AICPA does not have a position on which tax breaks to eliminate first; however, the AICPA is a long-time advocate for an efficient and pro-growth tax system based on the principles of good tax policy. We need a tax system that is fair, stimulates economic growth, has minimal compliance costs, and allows taxpayers to understand their tax obligations. These features of a tax system are achievable if principles of good tax policy are considered in the design of the system.

PREPARED STATEMENT OF DONALD B. MARRON, PH.D., INSTITUTE FELLOW, URBAN INSTITUTE AND URBAN-BROOKINGS TAX POLICY CENTER

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

America's business tax system is needlessly complex and economically harmful. Thoughtful tax reform can make our tax code simpler, boost American competitiveness, create better jobs, and promote shared prosperity.

Business tax reform will boost long-run economic growth if it inspires more investment in the United States and if firms make investments with higher social returns. With high statutory rates, numerous tax breaks, and deferral of overseas profits, our current system creates many perverse incentives. Corporations sometimes see a more favorable investment climate abroad, multinationals hoard money in overseas affiliates, different types of investment face widely varying tax rates, debt financing is favored over equity, new and small businesses struggle under disproportionate compliance costs, and businesses big and small invest too much in tax planning. Thoughtful tax reform can reduce these distortions, encourage businesses to invest more domestically, and reorient investment to opportunities that yield higher returns for society.

But as you know, tax reform is hard. Meaningful reforms create winners and losers—and you may hear more complaints from the latter than praise from the former. In hopes of making your job a little easier, my testimony addresses seven main points about business tax reform:

1. **Policymakers should be realistic about near-term growth from business tax reform.** The growth effects of more and better investment accrue gradually, with their largest effects beyond the 10-year budget window. If reform is revenue neutral, revenue raisers may temper future growth. If reform loses revenue—tax cuts mixed with reform—deficits may crowd out private investment. Either way, the boost to near-term growth may be modest, at least in the budget window. Dynamic scoring by the Joint Committee on Taxation, which reflects the mainstream economic view, will thus play only a small role in paying for tax reform.
2. **The corporate income tax makes our tax system more progressive; corporate tax cuts would thus particularly help people with high incomes.** Much of the burden from corporate income taxes falls on corporate shareholders and investors more broadly, people who tend to have high incomes. The rest of the burden falls on workers including executives, professionals, and managers as well as rank-and-file employees. Economists debate how much of the burden falls on workers, but overall it is clear that corporate tax reductions would particularly benefit those with high incomes. Workers will benefit most from reforms that encourage more and better investment in the United States.
3. **Taxing pass-through business income at a preferential rate would create new opportunities for tax avoidance.** When taxpayers see an opportunity to switch from a high tax rate to a lower one, they often take it. This is especially true when they can make the shift with a mere paper transaction, not a real change in economic behavior. Prominent examples include Kansas's experiment with eliminating taxes on pass-through income, S corporations' profits exemption from Medicare payroll taxes, and preferential rates for long-term capital gains. Taxpayers will react the same way if pass-through business income gets preferential treatment. Legislative and regulatory measures to limit tax avoidance will introduce new complexities, create arbitrary distinctions, and impose new administrative burdens.
4. **Limiting the top tax rate on pass-through business income would benefit only people with high incomes.** In the Better Way plan, House Republicans propose that pass-through business income be taxed at no more than 25 percent, well below the 33-percent rate they propose for wages, salaries, and other ordinary income. The only taxpayers who would benefit are those who have qualifying business income and have enough income to otherwise be in a higher tax bracket. Almost all tax savings would go to people in the top of the income distribution. Creating a complete schedule of pass-through rates could reduce this inequity, but it would also expand the pool of taxpayers tempted by tax avoidance.
5. **Taxing pass-through business income at the corporate rate would not achieve tax parity.** Owners of pass-through businesses face one layer of tax: individual income taxes on their share of business profits. Corporate shareholders face two layers. The company pays corporate income taxes on its profits, and taxable shareholders pay individual income taxes on their dividends and capital gains. Taxing pass-through business income at the corporate rate would thus favor pass-throughs over corporations. Tax parity requires either

a higher tax rate on pass-through business income, a new tax on pass-through distributions, or elimination of shareholder taxes.

6. **It is extremely difficult to pay for large cuts in business tax rates by limiting existing business tax breaks and deductions.** A new Tax Policy Center analysis finds that eliminating all corporate tax expenditures except for deferral could pay for lowering the corporate tax rate to 26 percent. To go any lower would require cutting other business deductions, such as for interest payments. But deductions lose value as tax rates fall. The more you cut rates, the harder it becomes to raise offsetting revenue by limiting tax breaks and other deductions. To pay for large rate reductions, lawmakers will therefore need to raise other taxes or introduce new ones. Options include raising taxes on shareholders, a value-added tax, and a carbon tax.
7. **Making business tax cuts retroactive to the start of 2017 would not promote growth and would benefit only shareholders.** Retroactive tax cuts would give a windfall to profitable businesses. That does little or nothing to encourage productive investment. Indeed, it could weaken growth by leaving less budget room for more pro-growth reforms. Retroactive tax cuts do not help workers; the benefits would go solely to shareholders.

I elaborate these points in the remainder of my testimony.

1. POLICYMAKERS SHOULD BE REALISTIC ABOUT NEAR-TERM GROWTH FROM BUSINESS TAX REFORM

Thoughtful business tax reform will encourage more and better investment in the United States. But the benefits of that investment will not show up immediately. They build gradually over time as businesses accumulate their stock of productive capital. The largest benefits may occur beyond the usual 10-year budget window.

Moreover, the potential growth from business tax reform will be offset, at least in part, by other aspects of reform. If reform is revenue neutral, revenue raisers may temper future growth. If reform reduces the corporate tax rate while slowing investment write-offs, for example, the net effects on investment and growth will reflect the growth penalty from slower write-offs along with any growth benefits from lower rates. Depending on the changes, the net effect could even slow growth. If reform loses revenue—tax cuts mixed with reform—deficits may crowd out private investment. Either way, the net boost to economic growth will be less than might be suggested by a narrow focus on the growth-increasing aspects of reform.

Policymakers should therefore be realistic about how much additional growth they can expect from business tax reform and how much dynamic scoring can help pay for its costs. Former Ways and Means Chairman Dave Camp's tax reform in 2014 provides a good example. His proposal reduced the corporate tax rate to 25 percent, but among the offsetting revenue raisers were limits on interest deductibility and slower depreciation. As a result, the Joint Committee on Taxation (2014) concluded that the plan would likely reduce future investment. The plan boosted economic activity modestly, because JCT believed other features would encourage people to work more. On net JCT expected Camp's plan to lift gross domestic product by a total of 0.1 to 1.6 percent over 10 years, yielding additional Federal revenues of $50 to $700 billion. Welcome amounts, to be sure, but modest relative to the revenue changes of large-scale business tax reform.

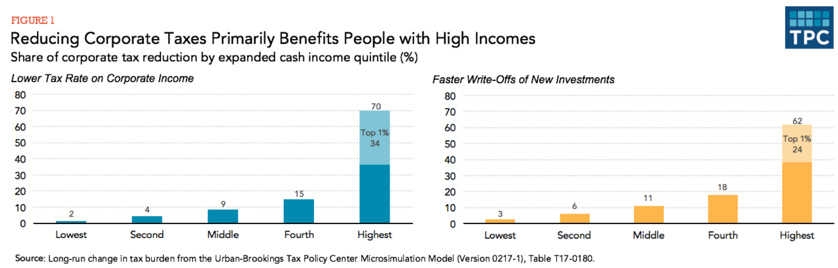
2. THE CORPORATE INCOME TAX MAKES OUR TAX SYSTEM MORE PROGRESSIVE

The burden of the corporate income tax falls on three types of people. Corporate shareholders bear some of the tax because it reduces the dividends and capital gains they receive. Owners of capital bear some of the tax because it reduces the return to capital in the economy more broadly. And workers bear some of the tax because it reduces the size and quality of the U.S. capital stock, which in turn reduces their wages, salaries, and benefits.

Debate continues about how much each group bears. Some individual studies suggest workers may bear as much as 60 to 70 percent of the corporate income tax. But many other studies find lower shares. Federal agencies estimate that workers bear 19 to 25 percent of the corporate income tax (Huang and Debot 2017).

My colleagues at the Tax Policy Center estimate that in the long run, 20 percent of changes in the corporate tax rate are ultimately borne by workers (Nunns 2012). The remainder is borne by corporate shareholders (60 percent) and capital owners generally (20 percent). Changes in investment write-off rules, however, can have a bigger effect on workers. Depreciation and expensing rules have a more direct effect on investment—and thus the productivity that drives wages, salaries, and benefits—than do changes in the corporate tax rate. TPC estimates that, in the long run, 50 percent of changes in depreciation rules and expensing are borne by workers and 50 percent by all capital.

In these discussions, terms like "workers" and "labor" refer to all types of workers, including highly paid executives, professionals, and managers. Economists expect increased investment to boost productivity and incomes across all types of jobs and decreased investment to do the reverse.



The benefits of cutting corporate income taxes thus go predominantly to people with high incomes. Under TPC's estimates, about 70 percent of the benefit from cutting corporate tax rates would go to people in the top fifth of the income distribution, with 34 percent going to people in the top 1 percent (figure 1). The benefits of accelerating investment write-offs would be somewhat less concentrated at the top, with 62 percent going to the top fifth by income and 24 percent to the top 1 percent.

3. TAXING PASS-THROUGH BUSINESSES AT PREFERENTIAL RATES WILL INSPIRE TAX AVOIDANCE

American businesses take many forms, from sole proprietors working from home to publicly traded multinationals that span the globe. The largest businesses are usually organized as C corporations, which pay the corporate income tax. Millions of sole proprietorships, partnerships, limited liability corporations, and S corporations, however, do not pay the corporate income tax. Instead, their owners pay ordinary income taxes on their share of profits. These entities are often called pass-throughs because for tax purposes their income passes through to their individual or owners.

Pass-throughs are an important economic force. They account for about 95 percent of all businesses and more than half of all business revenue (Looney and Krupkin 2017, Prisinzano et al. 2016).

Both President Trump and the Better Way plan have proposed that business income from pass-throughs be taxed at a lower maximum rate than wages, salaries, and other types of ordinary income. The Trump administration proposed that all business income be taxed at 15 percent, with a top individual tax rate of 35 percent. In their Better Way proposal, House Republicans proposed a 25 percent tax rate on pass-through business income, below their top 33 percent rate on ordinary income.

These rate differentials—20 percentage points under President Trump's proposal and 8 percentage points under the Better Way's—would create new avenues for tax avoidance. Taxpayers facing higher tax rates on their nonbusiness income would now get a big tax saving if they can recharacterize some of that income as business income. Highly paid professionals, for example, might provide services through LLCs and claim some portion of their compensation as business income.

Taxpayers clearly respond to such rate differentials. When Kansas exempted all pass-through income from its State income tax, with rates up to about 5 percent, Kansans responded by creating new LLCs, partnerships, and so on. State revenue plummeted without any apparent economic boost (DeBacker et al. 2016). At the Federal level, profits from S corporations are not subject to Medicare payroll taxes. The resulting rate differentials—2.9 percentage points through 2012, up to 3.8 percentage points since 2013—have inspired some professionals to route income through S corporations and treat it as profit rather than compensation (Burman and Rosenberg 2017). Preferential tax rates similarly encourage people to convert ordinary income into capital gains and dividends.

President Trump and the Better Way architects have both indicated they will introduce measures to curb avoidance. Legislative and regulatory measures can limit avoidance but will introduce new problems. Eligibility rules will create new complexity, create arbitrary distinctions (*e.g.,* between qualifying and nonqualifying businesses), and increase administrative costs. Enforcement will require Internal Revenue Service resources and impose new taxpayer burdens. And despite such efforts, some avoidance will still occur. Payroll tax avoidance through S corporations, for example, continues to be an issue today (Burman and Rosenberg 2017).

4. LIMITING THE TOP TAX RATE ON PASS-THROUGH BUSINESS INCOME WOULD BENEFIT ONLY PEOPLE WITH HIGH INCOMES

Proposals for a maximum tax rate on pass-through business income would overwhelmingly benefit people with high incomes for two reasons. First, people with high incomes are much more likely to have business income. The Tax Policy Center estimates, for example, that the top 1 percent receive more than half of pass-through business income. Second, maximum rates would help only taxpayers whose income is high enough that they would otherwise be in a higher tax bracket.

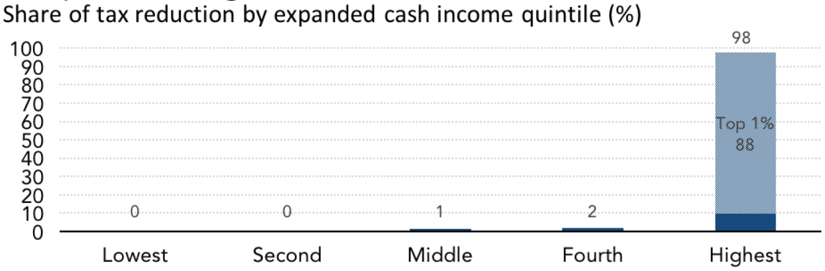
The benefits from a maximum tax rate on pass-through business income thus skew enormously to people with high incomes. Rohaly, Rosenberg, and Toder (2017) recently considered several scenarios in which business income from pass-throughs faces a maximum tax rate of 15 or 25 percent and with narrow and broad definitions of qualifying income. They estimated the effects of the maximum against a baseline of a 33-percent top individual tax rate and no alternative minimum tax, similar to leading Republican proposals. In all four cases, the benefits of a maximum tax tilt heavily to the high end. In the case with a 25-percent maximum rate and a broad definition of qualifying income, for example, they find that 88 percent of the tax savings go to people in the top 1 percent by income (figure 2).

One way to reduce this inequity would be to introduce a complete schedule of preferential rates for taxpayers at all income levels. If a reformed code has individual rates of 35 percent, 25 percent, and 10 percent, for example, the preferential rate schedule for pass-through business income might be 30 percent, 20 percent, and 5 percent. Benefits would still skew to people with the highest incomes because they receive the most business income. But this rate structure would eliminate the extra skew that comes from a maximum rate. On the other hand, this approach would greatly amplify concerns about tax avoidance. A maximum rate invites avoidance by the relatively few taxpayers with income high enough to benefit. A schedule of preferred rates invites avoidance by taxpayers at all income levels.

FIGURE 2

Capping Pass-through Tax Rates Benefits People with High Incomes

Share of tax reduction by expanded cash income quintile (%)



Source: Rohaly, Rosenberg, and Toder (2017), Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1), Table T17-0166.

Note: 25-percent top rate on a broad definition of pass-through business income. Measured against a baseline with a 33 percent top individual rate and no AMT.

5. TAXING PASS-THROUGH BUSINESS INCOME AT THE CORPORATE RATE WOULD NOT ACHIEVE TAX PARITY

In a perfect world, businesses would organize as corporations or pass-throughs based on business and personal considerations. In practice, taxes often drive those decisions.

Some observers have suggested that taxing pass-through and corporate income at the same rate would create a level playing field. The Main Street Tax Fairness Act (H.R. 5076 and S. 707), for example, would tax pass-through business income at the corporate tax rate. If the corporate rate fell, the pass-through rate would fall as well.

However, making these rates equal would not achieve parity. Business income from pass-throughs faces a single layer of tax: each owner pays individual income taxes on his or her share of business profits. Corporate income, however, faces two layers of tax: one when the company pays its taxes and the other when shareholders receive dividends or realize capital gains. Several factors limit the size of this second layer of tax. Most dividends and capital gains are taxed at preferential rates. Capital gains are not taxed until they are realized. And most corporate stock is held by tax-exempt and tax-deferred investors (Burman, Clausing, and Austin 2017). But accounting for all those factors, corporate income still faces higher taxes, on average, than does pass-through income.

Taxing pass-through business income at the corporate tax rate would thus not achieve parity. True parity requires that pass-through income face a higher tax rate than corporate income, that pass-through income face a second layer of tax, or that shareholder taxes be eliminated.

6. IT IS EXTREMELY DIFFICULT TO PAY FOR LARGE CUTS IN BUSINESS TAX RATES BY LIMITING EXISTING BUSINESS TAX BREAKS AND DEDUCTIONS

Tax policy experts have spent much of this decade trying to find enough payfors to lower the corporate tax rate to 25 or 28 percent, the rates targeted by Governor Romney and President Obama in the 2012 presidential campaign. In his 2014 proposal, Dave Camp demonstrated that a 25 percent rate might be technically possible but would require substantial cuts in existing tax breaks and limits on interest deductibility. The Tax Policy Center (2017) recently estimated that the corporate rate could be reduced to 26 percent without losing revenue in the long run if all corporate tax expenditures were eliminated except deferral. This would require eliminating such tax benefits as accelerated depreciation for machinery and equipment, expensing of investments for small businesses under section 179 of the code, expensing of research costs, the research credit, and the low-income housing credit, among others.

Today, some Republican proposals go much further, lowering the corporate rate to 15 to 20 percent. It is extremely difficult to pay for such large cuts by limiting business tax breaks and deductions alone. As TPC and JCT analyses indicate, getting the corporate rate into the mid-20s may use up all business tax breaks. And there's a second challenge: deductions lose value as tax rates fall. A deduction that costs $100 at today's 35 percent rate is worth only $80 at a 28 percent rate and only $43 at a 15 percent rate. The more you cut rates, the less budget savings you get by rolling back each deduction.

The only way to pay for large rate reductions is to increase other taxes or introduce new ones. One option is to raise taxes on shareholders, who get significant benefits from corporate tax reductions. Eric Toder and Alan Viard (2016) offer one approach, which would tax shareholder gains at ordinary income tax rates as they accrue rather than at realization. Another option is to introduce a value-added tax or a close relative like the destination-based cash flow tax. A third option is to introduce a carbon tax, which would discourage emissions of greenhouse gases and accelerate our move to cleaner energy sources.

7. RETROACTIVE TAX CUTS WOULD NOT BOOST GROWTH, WOULD BENEFIT ONLY SHAREHOLDERS

Some tax policy optimists once hoped reform would happen quickly, with many changes taking effect on January 1, 2017. With three-quarters of the year now behind us, some voices still argue for that start date, especially for any business tax cuts.

Making tax cuts retroactive would do little or nothing to promote economic growth. Indeed, it could weaken growth since it would leave less budgetary room to enact other pro-growth reforms. The purpose of business tax reform is not to put additional cash into the coffers of profitable businesses. Some slack may remain in our economy, but giving windfalls to businesses would provide little or no stimulus. Instead, the goal of business tax reform should instead be to change the financial incentives businesses face so they invest more and invest better here at home. Retroactive tax cuts fail to do that.

The benefits of retroactive tax cuts would go solely to shareholders, not to workers. A retroactive tax cut would thus be more regressive than forward-looking cuts in corporate tax rates or more favorable investment write-offs. The Tax Policy Center estimates that 76 percent of the benefits of a retroactive cut in corporate taxes would go to people in the top fifth of the income distribution (compared with 70 percent for forward-looking rate reductions and 62 percent for faster write-offs) and 40 percent to the top 1 percent (compared with 34 percent and 24 percent, respectively).

As 2017 draws to a close, lawmakers should focus on business tax reforms in 2018 and beyond.[1]

Thank you again for inviting me to appear today. I look forward to your questions.

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[1] One possible exception are the temporary tax provisions that expired at the end of last year but are widely expected to be extended. For my general views on these "tax extenders," *see* Marron (2012).

QUESTIONS SUBMITTED FOR THE RECORD TO DONALD B. MARRON

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

Question. Dr. Marron, I was particularly interested in your testimony regarding the incidence of the corporate income tax and your comment that "the benefits of cutting corporate income taxes thus go predominantly to people with high incomes." What I didn't find in your testimony is whether you believe it is nevertheless appropriate to reduce the statutory corporate income tax rate in tax reform, especially given that the U.S. corporate rate is regarded by almost everyone as globally uncompetitive. Would you please provide us your thoughts on that? I'm very curious to hear if your views are in line with the views of both former President Obama and President Trump on this issue.

Answer. Yes, I believe we should cut the statutory corporate tax rate. Our current system features an especially high statutory rate and numerous tax breaks. Tax considerations thus loom large—too large in my view—in corporate decision-making. Lowering the corporate rate and repealing many tax breaks would create a simpler, fairer, more competitive tax system.

Question. Dr. Marron, you identify in your testimony that growth effects in the near-term from tax reform may be modest, at least in the typical 10-year budget window used by congressional scorers. Growth had been stuck at a sluggish 2 percent or so, on average, during the previous administration, and some view continued sluggishness as some sort of destiny because of demographics and the like. However, even a quarter or half a percent sustained increase in economic growth would yield tremendous dividends, including dividends to middle-class Americans. Dr. Marron, I wonder if you agree that even a quarter or half a percent sustained increase in growth would be meaningful to Americans over the next 10 years, and whether the benefits would continue after that.

Answer. The impacts of faster economic growth depend on how much growth accelerates, why it accelerates, and how the gains from growth are shared in society. If tax reform somehow lifts productivity growth by a quarter of a percent annually over the next decade and if those gains are broadly shared, then many Americans would see significant benefits. (If the growth came from increased labor supply, the benefits of increased economic activity would have to be weighed against the opportunity cost of shifting people's time from other activities.)

For example, consider a family with $50,000 of income in 2017. Today their income might be expected to grow about 2 percent annually, reaching $61,000 in 2027. If it grew at 2.25 percent instead, their income would be $62,500 in 2027. That $1,500 gain is a real benefit.

Note, however, that their gain would be only $125 in the first year of higher growth and only $500 in 2021. The benefits of faster growth take time to accumulate.

This example considers a scenario in which tax reform would lift productivity growth by 0.25 percentage points in each of the next 10 years, raising the level of economic activity by about 2.5 percent in 2027. That would be a tremendous accomplishment, far beyond what I would expect from the Framework or related proposals.

Question. Dr. Marron, you seem to put forward a Gordian knot in your testimony regarding pass-through businesses. On the one hand, lowering rates for pass-throughs would, as you suggest, create new opportunities for tax avoidance. On the other hand, you seem to indicate that attending to the issue by attempting to put up guardrails to deal with those opportunities for avoidance could impose new complexities, create arbitrary distinctions, and impose new administrative burdens. Dr. Marron, does that mean that nothing can be done to lower taxes on pass-throughs?

Answer. It is a mistake to think of recent proposals as trying to lower taxes on pass-through businesses. Instead, they are proposals to lower taxes on a select group of pass-through businesses.

The Framework proposal, for example, would create a 25-percent maximum tax rate on pass-through income. This would do nothing to reduce taxes for the vast majority of pass-through entities whose income is already taxed at 25 percent or less.

Lawmakers understandably want to limit the benefits of the special rate even further. To do so requires some way of distinguishing pass-through income that "deserves" a lower rate from pass-through income that doesn't. As I said in my testimony, any effort to do will impose new complexities, create arbitrary distinctions, impose new administrative burdens, and invite gaming by high-income taxpayers. Congress can try to limit those problems with simple, broad-brush rules such as allowing the lower rate for only 30 percent of pass-through income. By itself, however, that does nothing to focus the benefit on "deserving" businesses or to discourage game playing.

Question. Dr. Marron, in testimony before a House Committee in 2014, you identified IRS research that estimated that corporations and partnerships spent more than $100 billion complying with the Federal income tax code for tax year 2009. Furthermore, you identified that small businesses bear the majority of those costs, with, at the time, $66 billion borne by businesses with less than $1 million in revenue and $91 billion for businesses with less than $10 million in revenue. Given such high costs of compliance, which largely fall on smaller businesses, do you believe that tax reform that simplifies the tax system for businesses could meaningfully reduce those compliance costs, especially for smaller businesses?

Answer. Reducing compliance burdens on responsible small businesses should be a priority for reform. Increasing section 179 expensing and expanding eligibility for cash accounting are two ways to do so.

Question. Dr. Marron, you favor expensing and believe it should be a higher priority for Congress than a reduction of the corporate tax rate. I understand one of the main arguments for such prioritization is that a corporate tax rate cut, while incentivizing new investment is, in large part, a windfall to old capital. That is, a corporate rate cut gives a benefit to income that would have been generated anyway. Expensing, on the other hand, only gives a tax benefit to new investments, so wouldn't be granting windfall benefits. Am I stating that argument correctly?

Answer. As you say, one concern about cutting the corporate tax rate is that companies would pay lower taxes on profits that result from decisions and investments they have already made. That's a pure windfall to the companies. Another concern is that companies would pay lower taxes in the future on what economists call their super-normal returns, *i.e.,* the profits they make in excess of their cost of capital. Expensing avoids both of these problems. It applies only to new investments, not past ones. And it applies only to the normal profits from investing, not the super-normal profits.

Question. But I also want to ask, couldn't expensing also result in a windfall benefit? That is, if a business was going to invest $100 million, say, in capital equipment under the Alternative Depreciation System (ADS), then to allow the $100 million to all be deducted in the first year of such investment, to allow it to be expensed, wouldn't that be giving a tax benefit for activity that would have happened anyway? Shouldn't that be considered a windfall benefit?

Answer. I would draw a distinction here between a windfall benefit and what economists call an inframarginal benefit. Cutting the corporate tax rate creates a windfall for companies that have made profitable investments in the past. Expensing doesn't have that problem. But both expensing and lowering the corporate rate raise the issue you mention—some of the benefit would accrue on investments that businesses would have made in the United States anyway. Lowering taxes on these inframarginal investments does nothing to incentivize new investment.

Question. Finally, would one way to address this problem be to allow full expensing for capital expensing that exceeds some base account, similar to how is done with the R&D credit? (With the R&D credit the point of that is that the R&D credit is targeted on research that would not have happened anyway, that would not have happened but for the credit.) Perhaps this could be a way to get most of the same growth effect from expensing, but while limiting the revenue costs.

Answer. This approach makes some sense conceptually, but would be difficult to implement in practice. The dividing line between marginal and inframarginal investments changes constantly as economic conditions evolve and as individual businesses gain and lose market share.

Question. Mr. Marron, you write that if tax reform loses revenue, the resulting deficits may crowd out private investment. Could you please explain that more?

Answer. If tax reform loses revenue, the Federal Government has five options for making up the difference. It could raise future taxes, reduce future spending, sell public assets, print more money, or borrow. In my testimony, I focused on the scenario with more borrowing. In that case, the borrowed resources must come from some combination of increased private saving, reduced private investment, and capital inflows from abroad. Based on research by the Congressional Budget Office and others, I expect that a material amount of the resources will come from reduced private investment. That "crowding out" will reduce the future capital stock and reduce the economic gains from tax reform.

Question. Dr. Marron, you seem to think that a move towards expensing would be more helpful to the economy than would a corporate rate cut. But I will tell you that many corporations I hear from seem to prefer the corporate rate cut. Why do you think that is? How much of that has to do with financial accounting—and if so, how much should policymakers take that into account?

Answer. Several factors are at play here. First, the magnitude of the potential tax cuts differs. Corporations would get a bigger benefit from a large cut in the corporate rate than from a move to full expensing. Second, as you note, some corporations may prefer the financial accounting implications of a corporate tax cut (although companies with unused net operating losses may dislike it). I do not think policymakers should give these concerns much weight. Responsible management should focus on the economic value they create, not how it may appear in financial statements. That said, there is some evidence that financial accounting for taxes does influence corporate decisions and, in particular, that a focus on financial accounting can weaken the investment incentives from full expensing.

Question. Dr. Marron, if investment in capital assets were allowed to be expensed, should there be exceptions to this for LIFO? For land? For real estate improvements?

Answer. In principle, a consumption-based tax system would allow expensing for all assets, whether equipment, structures, inventory, or land. Such a system would also forbid tax deductions for interest payments from any debt financing these investments.

In practice, lawmakers may want to focus consumption tax treatment on assets that are most sensitive to taxes, while maintaining income tax treatment for assets that are less sensitive. Land is an obvious candidate, since taxes have little effect on the amount of land available for productive use.

Questions Submitted by Hon. Ron Wyden

Question. Dr. Marron, there is no question that tax reform needs to make American businesses more competitive. But one of the central questions of this hearing is who primarily benefits from corporate rate cuts.

Treasury, CBO, JCT, and the Tax Policy Center all find that roughly three-quarters of the benefit from a corporate rate cut would benefit shareholders and owners of capital—most of whom are wealthy. I know the Tax Policy Center has gone even further and looked at the benefits by income category.

Can you tell the committee how much of a windfall the wealthiest 1 percent would receive from a corporate rate cut?

Rather than looking at the economic consensus by CBO, JCT, Treasury, and TPC, some on this committee choose to cherry-pick one-off studies from economists outside the mainstream who agree with their political views.

I assume the Tax Policy Center didn't just pull their figures out of thin air. Could you explain how TPC arrived at its estimates, and how they differ from those studies that are outside of the mainstream?

Answer. The Tax Policy Center estimates that 34 percent of the benefit from cutting the corporate tax rate would go to households in the top 1 percent of the income distribution.

The Tax Policy Center estimates that, in the long run, 20 percent of the corporate income tax burden falls on workers, 60 percent on corporate shareholders, and 20 percent on all capital investors overall. Senior fellow Jim Nunns explains the evidence underlying those estimates in "How TPC Distributes the Corporate Income Tax." He reviewed the extensive theoretical and empirical literature on the incidence of corporate income taxes.

Studies that find that most of the corporate burden falls on workers differ from the mainstream in three main ways. First, those studies often assume that the United States is a small, open economy. Under that assumption, capital moves quickly and easily in response to tax changes, shifting most or all the burden to domestic workers. In reality, the United States is a very large economy, so some of the burden will be borne by domestic capital. Second, those studies often focus on the normal returns to investment, but ignore super-normal returns, *i.e.,* profits in excess of a normal rate of return. Taxes on normal returns are much more likely to fall on workers than are taxes on super-normal returns. Third, some of those studies try to estimate the incidence of the corporate income tax by comparing wages and taxes in different countries over time. Unfortunately, it is difficult to control for all relevant factors in doing those comparisons, resulting in some studies with implausible estimates of the burden on workers.

Question. Dr. Marron, earlier this year the Tax Policy Center estimated the economic impact of the House Republican tax plan. It found that the plan would cost more than $3.5 trillion over the first 10 years and as much as $9 trillion by the end of the second decade.

The study also found that this massive debt-finance tax cut would begin dragging down the economy within the first 10 years and would shrink the economy by more than 2.5 percent by the end of the second decade.

Please explain to the committee the risks debt-financed tax cuts pose to the economy.

Answer. Tax reforms that encourage new, productive private investment and expand the labor supply can boost our economy. Additional deficits, however, can offset those gains. With our economy near full employment, deficits will either crowd out some private investment, attract investment from abroad (thus directing some economic gains to overseas investors), or a combination of both. Debt-financed tax cuts thus create a race between the potential economic gains from tax reductions and the economic losses from higher deficits. In practice, the conventional economic models used by CBO, JCT, and TPC find that the deficit effects eventually win. Debt-financed tax cuts thus undermine long-run economic growth.

QUESTIONS SUBMITTED BY HON. BILL NELSON

Question. If you can, please provide some suggestions on how the President could achieve some of his stated objectives for business tax reform—including (1) reducing complexity in the tax code and hours spent on tax-related paperwork and (2) sustaining 3-percent economic growth or higher.

Answer. Small businesses bear a disproportionate share of the compliance burden from our tax system. Expanding section 179 expensing and cash accounting could ease the burden somewhat for these businesses. Lawmakers should also ensure that changes to the code, such as special treatment for pass-throughs, not create new complexities and compliance burdens.

We've enjoyed two consecutive quarters of 3 percent economic growth. But achieving persistent 3-percent growth over the next decade is unlikely, even with pro-growth reforms. Pro-growth reforms include reducing the corporate tax rate, allowing full expensing of new investments (especially for smaller businesses), reducing the mortgage interest deduction (which directs too much domestic capital into single-family homes), expanding the Earned Income Tax Credit (which brings more people into the workforce), and limiting the extent to which tax changes increase long-term deficits.

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. No, I do not. There is no need for a major tax cut. The economy has largely recovered from the financial crisis, and revenues are near historical averages relative to the size of the economy. Looking ahead, the fiscal pressures of our aging population and rising health-care costs will likely require significant fiscal adjustments, reducing the growth of spending and raising the trajectory of revenues. Given that context, there is no sense is cutting entitlement programs to pay for tax cuts today.

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 see any politically acceptable way to reduce the top business tax rate to 15 percent. Making up the lost revenue will simply be too challenging. That said, my colleagues at the Tax Policy Center have explored several ways to make a 15-percent rate work. These include:

- Jim Nunns, "Neutral Tax Reform with 15-Percent Business Income Tax Rate," which applies a 15-percent tax rate to corporations and pass-throughs.
- Eric Toder and Alan Viard, "Replacing Corporate Revenues with a Mark-to-Market Tax on Shareholder Income," which lowers the corporate rate to 15 percent and makes up revenue by taxing shareholders.
- Donald Marron and Eric Toder, "Carbon Taxes and Corporate Tax Reform," which explores how revenue from a carbon tax could help pay for lowering the corporate tax rate (this analysis considers corporate tax rates in the 20s, but a larger carbon tax could help get the rate to 15 percent).

Question. Please provide any suggestions you have for how to reform the tax code for businesses without increasing income inequality.

Answer. One way to limit the degree to which business tax reform increases income inequality is to focus on revenue neutral policy changes. For example, policymakers could allow full expensing of new business investment and pay for it by rolling back other tax breaks or by limiting interest deductibility. Designed well, such revenue neutral reforms can encourage new investment—helping workers throughout the income distribution—without providing a net tax cut to business owners, who tend to have higher incomes.

Another approach is to pair business tax reductions with expanded credits in the individual income tax. For example, reductions in the corporate income tax rate could be combined with an expanded Child Tax Credit, an expanded Earned Income Tax Credit, or a new family credit to ensure that benefits flow to people throughout the income distribution. The overall distributional effect will depend, however, on how those tax reductions are ultimately paid for.

Prepared Statement of Hon. Ron Wyden, a U.S. Senator From Oregon

Before I get to the substance of today's hearing, I need to address what's coming down the pike in this committee and on the Senate floor. And nothing I'm about to say should take away from our friendship, Mr. Chairman, or the fact that we've been able to get some important work done over the last several weeks, particularly with respect to CHIP.

Last night the majority announced, without consulting the minority, that on Monday the Finance Committee will hold a hearing on the Graham-Cassidy-Heller health-care proposal. I want to make clear that this is an abomination. It's an abomination of the process, it's an abomination of the substance, and it's an abomination of the history of this storied committee. First of all, this bill is a prescription for suffering and disastrous consequences for millions of Americans. Second, the CBO has informed the Congress that it'll be several weeks at the very least before it can provide full estimates for the bill. So this means the majority will be charging ahead with a radical, destructive transformation of our health-care system with the American people still in the dark. This bill's going to be a few roll call votes away from the President's desk and Republicans will not have answers to the basic threshold questions: What will happen to premiums? What will happen to coverage?

The idea that a bill this destructive and far-reaching can swing through the Finance Committee for a single hearing on a Monday morning and hit the Senate floor a day or two later makes a mockery of the legislative process Senator McCain urged us to return to.

Furthermore, this abomination of a process stands in stark contrast to what this committee has been able to achieve with respect to the Children's Health Insurance Program. But unfortunately, just when this committee ought to be celebrating a big victory for the millions of kids who count on CHIP, the Graham-Cassidy-Heller proposal threatens the health care of millions of children and families.

Second point: the reconciliation process relies on secrecy, speed, and brute force to ram partisan bills through the Senate, and it's been an absolute trainwreck on health care. But Leader McConnell is committed to Reconciliation Round Two on tax reform. And that means another secretive, partisan bill coming together behind closed doors—which leads me to a few points on the substance of today's hearing.

The details leaking out of the "Big Six" meetings paint a clear picture of an unprecedented tax giveaway for the most fortunate and biggest corporations. The centerpiece could very well be a $2-trillion loophole having to do with what's called pass-through status.

Pass-through status is supposed to be about helping small businesses, and there's no question that small businesses—who fuel local economies and hire the most workers—need a boost in tax reform. But any tax change that allows tax cheats to abuse pass-through status by "self-declaring" to avoid paying their fair share and dodge Social Security taxes would be worse than what's on the books today. The day the pass-through loophole becomes law would be Christmas morning for tax cheats. It would make a mockery of the Trump pledge that, quote, "the rich will not be gaining at all with this plan." And that's just one element of what's on offer.

Bottom line, it's time for the Congress to take the lies out of the corporate tax rate in America. Many of the biggest corporations in the country employ armies of lawyers and accountants who know all the tax tricks. They winnow their tax rates down to the low teens, single digits, even zero. So the Congress cannot pair a big corporate rate cut with a plan to enshrine a vast array of loopholes that let corporations off the hook for paying their fair share. That's a surefire way of heaping a heavier burden onto the middle class.

I hope the committee is able to take a close look at those issues today. As I mentioned, I'll be in and out this morning as I have an engagement with the Commerce Committee, but I look forward to returning for questions as soon as I'm able.

Thank you, Chairman Hatch.

COMMUNICATIONS

A CALL TO INVEST IN OUR NEIGHBORHOODS (ACTION) CAMPAIGN

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The A Call To Invest in Our Neighborhoods (ACTION) Campaign is 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). We thank Chairman Orrin Hatch and the Committee for holding this critically important hearing, and we appreciate the opportunity to provide feedback on business tax reform.

We are especially grateful for Finance Committee Chairman Hatch's and Committee member Senator Maria Cantwell's leadership in championing legislation to expand and strengthen the Housing Credit, our nation's primary tool for encouraging private investment in affordable rental housing. We strongly urge the Committee to advance this critical bill, the Affordable Housing Credit Improvement Act of 2017 (S. 548) this year, and protect both the Credit and multifamily Housing Bonds—a central component of the Housing Credit program—as part of any tax reform effort considered by Congress.

The Housing Credit is a Critical Part of Our Corporate Tax System

The use of the tax code to provide affordable rental housing through the Housing Credit and multifamily Housing Bonds has been one of the most important successes of the current business tax system. President Reagan and the Congress showed remarkable foresight when they created the Housing Credit as part of the Tax Reform Act of 1986. The Housing Credit is now our nation's most successful tool for encouraging private investment in the production and preservation of affordable rental housing, with a proven track record of creating jobs and stimulating local economies. For over 30 years, the Housing Credit has been a model public-private partnership program, bringing to bear private sector resources, market forces, and state-level administration to finance more than 3 million affordable apartments—nearly one-third of the entire U.S. inventory—giving more than 7 million households, including low-income families, seniors, veterans, and people with disabilities, access to homes they can afford. Roughly 40 percent of these homes were financed in conjunction with multifamily Housing Bonds, which are an essential component of the program's success.

The Housing Credit differs from many other corporate tax expenditures, which subsidize activity that still may occur without a tax benefit. In contrast, virtually no affordable rental housing development would occur without the Housing Credit. It simply costs too much to build rental housing to rent it at a level that low-income households can afford. In order to develop new apartments that are affordable to renters earning the full-time minimum wage, construction costs would have to be 72 percent lower than the current average.

Jeffrey D. DeBoer, President and CEO at the Real Estate Roundtable, who testified before the Committee as part of this hearing, recognized the Housing Credit's special standing within the corporate tax system. DeBoer's written testimony notes that the Housing Credit is an example of a tax incentive that is "needed to address market failures and encourage capital to flow to socially desirable projects."

Also, unlike most other corporate tax expenditures, substantially all of the net benefits of the Housing Credit go to low-income families, not corporations. This is because the Housing Credit is a purchased tax benefit, and corporations must pay in advance for the credit they receive. While corporations are the intermediaries who claim the credits in order to deliver private resources to affordable rental housing to low-income populations, it is the low-income families who live in these homes that the credit ultimately serves.

The Housing Credit is a Proven Solution to Meet a Vast and Growing Need

Despite the Housing Credit's tremendous impact, there are still 11.1 million renter households—roughly one out of every four—who spend more than half of their income on rent, leaving too little for other necessary expenses like transportation, food, and medical bills. This crisis is continuing to grow. HUD reports that as of 2015, the number of households with "worst case housing needs" had increased by 38.7 percent over 2007 levels, when the recession began, and by 63.4 percent since 2001. A study by Harvard University's Joint Center for Housing Studies and Enterprise Community Partners estimates that the number of renter households who pay more than half of their income towards rent could grow to nearly 15 million by 2025.

The Housing Credit transforms lives by providing quality, affordable homes to people in need. It plays a critical role in financing housing for families, seniors, persons with disabilities, veterans, and more. The Housing Credit is also central to the revitalization of Public Housing through HUD's Rental Assistance Demonstration (RAD). Since RAD was established in 2012, the Housing Credit has leveraged nearly $1.7 billion to help recapitalize almost 28,000 homes.

The Housing Credit Creates Jobs

Housing Credit development supports jobs—roughly 1,130 for every 1,000 Housing Credit apartments developed, according to the National Association of Home Builders (NAHB). This amounts to roughly 96,000 jobs per year, and more than 3.4 million since the program was created in 1986. NAHB estimates that about half of the jobs created from new housing development are in construction. Additional job creation occurs across a diverse range of industries, including the manufacturing of lighting and heating equipment, lumber, concrete, and other products, as well as jobs in transportation, engineering, law, and real estate.

The Housing Credit Stimulates Local Economies and Improves Communities

The Housing Credit has a profound and positive impact on local economies. NAHB estimates that the Housing Credit adds $9.1 billion in income to the economy and generates approximately $3.5 billion in federal, state, and local taxes each year.

Conversely, a lack of affordable housing negatively impacts economies. Research shows that high rent burdens have priced out many workers from the most productive cities, resulting in 13.5 percent foregone GDP growth, a loss of roughly $1.95 trillion, between 1964 and 2009.

Housing Credit development also positively impacts neighborhoods in need of renewal. About one-third of Housing Credit properties help revitalize distressed communities. Stanford University research shows Housing Credit investments improve property values and reduce poverty, crime, and racial and economic isolation, generating a variety of socio-economic opportunities for Housing Credit tenants and neighborhood residents.

Affordable Housing Improves Low-Income Households' Financial Stability

Affordable housing promotes financial stability and economic mobility. It leads to better health outcomes, improves children's school performance, and helps low-income individuals gain employment and keep their jobs. Affordable housing located near transportation and areas with employment opportunities provides low-income households with better access to work, which increases their financial stability and provides employers in those areas with needed labor.

Families living in affordable homes have more discretionary income than low-income families who are unable to access affordable housing. This allows them to allocate more money to other needs, such as health care and food, and gives them the ability to pay down debt, access childcare, and save for education, a home down payment, retirement, or unexpected needs.

The Housing Credit is a Model Public-Private Partnership

The Housing Credit is structured so that private sector investors provide upfront equity capital in exchange for a credit against their tax liability over 10 years, which only vests once the property is constructed and occupied by eligible households paying restricted rents. This unique, market-based design transfers the risk from the taxpayer to the private sector investor. In the rare event that a property falls out of compliance during the first 15 years after it is placed in service, the Internal Revenue Service can recapture tax credits from the investor. Therefore, it is in the interest of the private sector investors to ensure that properties adhere to all program rules, including affordability restrictions and high-quality standards—adding a unique accountability structure to the program.

The Housing Credit is State Administered With Limited Federal Bureaucracy

The Housing Credit requires only limited federal bureaucracy because Congress wisely delegated its administration and decision-making authority to state government as part of its design. State Housing Finance Agencies, which administer the Housing Credit in nearly every state, have statewide perspective; a deep understanding of the needs of their local markets; and sophisticated finance, underwriting, and compliance capacity. States develop a system of incentives as part of their Qualified Allocation Plans (QAP), which drives housing development decisions, including property siting, the populations served, and the services offered to residents. States are also deeply involved in monitoring Housing Credit properties, including compliance audits and reviews of financial records, rent rolls, and physical conditions.

The Demand for Housing Credits Exceeds the Supply

Viable and sorely needed Housing Credit developments are turned down each year because the cap on Housing Credit authority is far too low to support the demand. In 2014—the most recent year for which data is available—state Housing Credit allocating agencies received applications requesting more than twice their available Housing Credit authority. Many more potential applications for worthy developments are not submitted in light of the intense competition, constrained only by the lack of resources.

The scarcity of Housing Credit resources forces state allocating agencies to make difficult trade-offs between directing their extremely limited Housing Credit resources to preservation or new construction, to rural or urban areas, to neighborhood revitalization or developments in high opportunity areas, or to housing for the homeless, the elderly, or veterans. There simply is not enough Housing Credit authority to fund all of the properties needed, but with a substantial increase in resources, many more of these priorities would be addressed—and the benefits for communities would be even greater.

Though the need for Housing Credit-financed housing has long vastly exceeded its supply, Congress has not increased Housing Credit authority permanently in 16 years.

We Urge Congress to Expand and Strengthen the Housing Credit

To meaningfully grow our economy and address our nation's growing affordable housing needs through tax reform, we urge Congress to increase the cap on Housing Credit authority by 50 percent. Such an expansion would support the preservation and construction of up to 400,000 additional affordable apartments over a 10-year period. We also call on Congress to retain the tax exemption on multifamily Housing Bonds, which are essential to Housing Credit production.

S. 548, which would authorize such an expansion, has earned strong bipartisan support in the Senate and among Senate Finance Committee members.

This legislation would increase Housing Credit allocation authority by 50 percent phased in over 5 years, and enact roughly two dozen changes to strengthen the program by streamlining program rules, improving flexibility, and enabling the program to serve a wider array of local needs. For example, S. 548 would encourage Housing Credit development in rural and Native communities, where it is currently more difficult to make affordable housing developments financially feasible; Housing Credit developments that serve the lowest-income tenants, including veterans and the chronically homeless; the development of mixed-income properties; the preservation of existing affordable housing; and development in high-opportunity areas. The legislation would also generate a host of benefits for local communities, including raising local tax revenue and creating jobs.

We also encourage Congress to make adjustments to the Housing Credit necessary to offset the impact that a lower corporate tax rate would have on Housing Credit investment. Senator Cantwell raised this important point during the hearing, when she noted that just the prospect of a lower corporate tax rate over the last year has resulted in lower pricing of Housing Credits by investors. This has impacted production at a time when our nation's shortage of affordable housing is vast and growing. However, Congress could negate the negative impact on the Housing Credit created by a lower corporate tax rate by making adjustments to the Housing Credit program's discount rate. Members of ACTION stand ready to help the Committee make these modifications to the program, which are outside the scope of S. 548, and ensure that affordable housing production continues at a robust level regardless of other changes made in tax reform.

An investment in the Housing Credit is an investment in individuals, local communities, and the economy. It transforms the lives of millions of Americans, many of whom are able to afford their homes for the first time—and it transforms their communities and local economies. The ACTION Campaign applauds the leadership the Senate Finance Committee has shown in support of the Housing Credit to date and urges the Committee to expand and strengthen the Housing Credit and multifamily Housing Bonds.

ACTION Campaign Co-Chairs
National Council of State Housing Agencies
Enterprise Community Partners

ACTION Campaign Steering Committee Members
Affordable Housing Tax Credit Coalition
Council for Affordable and Rural Housing
Council of Large Public Housing Authorities
CSH
Housing Advisory Group
Housing Partnership Network
LeadingAge
Local Initiatives Support Corporation/National Equity Fund
Make Room
National Association of Affordable Housing Lenders
National Association of Home Builders
National Association of Housing and Redevelopment Officials
National Association of Realtors
National Association of State and Local Equity Funds
National Housing and Rehabilitation Association
National Housing Conference
National Housing Trust
National Low Income Housing Coalition
National Multifamily Housing Council
Stewards of Affordable Housing for the Future
Volunteers of America

For a full list of ACTION Campaign members, visit *www.rentalhousingaction.org*.

AMERICAN FARM BUREAU FEDERATION

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The American Farm Bureau Federation is the country's largest general farm organization, with nearly 6 million member families and representing nearly every type of crop and livestock production across all 50 states and Puerto Rico. Our members grow and produce the food, fiber, and fuel that propel our nation's economy as well as putting food on our tables. According to USDA, 11 percent of U.S. employment comes from the agriculture and food industry, accounting for 21 million jobs of which about 18 million are off-the-farm positions.

Federal tax policy affects the economic behavior and well-being of farm households as well as the management and profitability of farm and ranch businesses. Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment, and entrepreneurship.

Farms and ranches operate in a world of uncertainty. From unpredictable commodity and product markets to fluctuating input prices, from uncertain weather to insect or disease outbreaks, running a farm or ranch business is challenging under the best of circumstances. Farmers and ranchers need a tax code that recognizes the financial challenges that impact agricultural producers. They want a tax code that doesn't make the challenging task of running a farm or ranch business more difficult than it already is.

Farm Bureau supports tax laws that help the family farms and ranches that grow America's food and fiber, often for rates of return that are modest compared to other business. What is needed is tax reform that supports high-risk, high-input, capital-intensive businesses like farms and ranches that predominantly operate as sole proprietors and pass-through entities. We believe that tax reform should be equitable and designed to encourage private initiative and domestic economic growth.

Farm Bureau commends the Committee on Finance for holding a hearing on business tax reform. The statement that follows focuses on and provides additional commentary on the tax reform issues most important to farmers and ranchers.

COMPREHENSIVE TAX REFORM WILL BOOST FARM AND RANCH BUSINESSES

Any tax reform proposal considered by Congress must be comprehensive and include individual as well as corporate reform and rate reduction. By far, the most common form of farm ownership is as a sole-proprietor. In total, farms and ranches operated as individuals, partners and S corporation shareholders constitute about 94 percent of our nation's 2 million farms and ranches and about 85 percent of total agricultural production. Because many business deductions and credits are used by both corporate and pass-through businesses, their elimination without substantial rate reduction for all business entities could result in a tax increase for the vast majority of farmers and ranchers.

LOWER EFFECTIVE TAX RATES WILL BENEFIT FARM AND RANCH BUSINESSES

Farm Bureau supports reducing effective tax rates and views this as the most important goal of tax reform. Tax reform that lowers rates by expanding the base should not increase the overall tax burden (combined income and self-employment taxes) of farm and ranch businesses.

Because profit margins in farming and ranching are tight, farm and ranch businesses are more likely to fall into lower tax brackets. Tax reform plans that fail to factor in the impact of lost deductions for all business entities and for all rate brackets could result in a tax increase for agriculture.

Farming and ranching is a cyclical business. A period of prosperity can be followed by one or more years of low prices, poor yields or even a weather disaster. Without the opportunity to even out income over time, farmers and ranchers will pay more than comparable non-cyclical businesses. Tax code provisions like income averaging allow farmers and ranchers to pay taxes at an effective rate equivalent to a business with the same aggregate, but steady revenue stream. Farm savings accounts would accomplish the same objective plus allow a farmer or rancher to reserve income in a dedicated savings account for withdrawal during a poor financial year. Installment sales of land benefit both buyers and sellers by providing sellers with an even income flow and buyers with the ability to make payments over time.

ACCELERATED COST RECOVERY HELPS FARMERS REMAIN EFFICIENT

Farmers and ranchers need to be able to match income with expenses in order to manage their businesses through challenging financial times. Expensing allows farm and ranch businesses to recover the cost of business investments in the year a purchase is made. In addition to Section 179 small business expensing, the tax code also provides immediate cost recovery through bonus depreciation and through long-standing provisions that allow for the expensing of soil and water conservation expenditures, expensing of the costs of raising dairy and breeding cattle and for the cost of fertilizer and soil conditioners such as lime. Farm Bureau supports the expansion of immediate expensing.

Because production agriculture has high input costs, Farm Bureau places a high value on the immediate write-off of all equipment, production supplies and pre-productive costs. While Section 179 does provide full expensing for most small and mid-size farms, USDA reports that almost a quarter of the large farms that account for nearly half of all agricultural production made investments exceeding the expensing limit in 2015. Thus, an expansion of immediate expensing has the potential to change the investment behavior of farms responsible for a significant amount of agriculture production.

When farmers are not allowed immediate expensing they must capitalize purchases and deduct the expense over the life of the property. Accelerated deductions reduce taxes in the purchase year, providing readily available funds for upgrading equipment, to replace livestock, to buy production supplies for the next season and for farmers to expand their businesses. This is not only a benefit to production agriculture; a study in the journal Agricultural Finance Review found that for every $1,000 increase to the Section 179 expensing amount, farms that had been previously limited by the expensing amount made an incremental capital investment of between $320 and $1,110.

CASH ACCOUNTING HELPS FARM AND RANCH BUSINESSES TO CASH FLOW

Cash accounting is the preferred method of accounting for farmers and ranchers because it allows them to match income with expenses and aids in tax planning. Farm Bureau supports the continuation of cash accounting.

Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This provides the flexibility farmers need to plan for major business investments and in many cases provides guaranteed availability of some agricultural inputs.

Under a progressive tax rate system, farmers and ranchers, whose incomes can fluctuate widely from year to year, will pay more total taxes than taxpayers with more stable incomes. The flexibility of cash accounting also allows farmers to manage their tax burden on an annual basis by controlling the timing of revenue to balance against expenses and target an optimum level of income for tax purposes.

Loss of cash accounting would create a situation where a farmer or rancher might have to pay taxes on income before receiving payment for sold commodities. Not only would this create cash flow problems, but it also could necessitate a loan to cover ongoing expenses until payment is received. The use of cash accounting helps to mitigate this challenge by allowing farm business owners to make tax payments after they receive payment for their commodities.

DEDUCTING INTEREST EXPENSE IS IMPORTANT FOR FINANCING

Debt service is an ongoing and significant cost of doing business for farmers and ranchers who typically rely on borrowed money to buy production inputs, vehicles and equipment, and land and buildings. Interest paid on these loans should be deductible because interest is a legitimate business expense. According to the USDA Economic Research Service, interest expense accounts for 17.9 percent of fixed expenses for farms and ranches. Immediate expensing will not offset the loss of this deduction, especially for the bulk of farmers and ranchers currently covered under Section 179 small business expensing.

Farm and ranch businesses are almost completely debt financed with little to no access to investment capital to finance the purchase of land and production supplies. In 2015, all but 5 percent of farm sector debt was held by banks, life insurance companies and government agencies. Without a deduction for interest, it would be harder to borrow money to purchase land and production inputs and the agriculture sector could stagnate.

Land has always been farmers' greatest asset, with real estate accounting for 79 percent of total farm assets in 2015. Since almost all land purchases require debt financing, the loss of the deduction for mortgage interest would make it more difficult to cash flow loan payments and could even make it impossible for some to secure financing at all. The need for debt financing is especially critical for new and beginning farmers who need to borrow funds to start their businesses.

REPEALING ESTATE TAXES WILL AID IN FARM TRANSITIONS

Estate taxes disrupt the transition of farm and ranch businesses from one generation to the next. Farm Bureau supports estate tax repeal, opposes the collection of capital gains taxes at death, and supports the continuation of unlimited stepped-up basis.

Farming and ranching is both a way of life and a way of making a living for the millions of individuals, family partnerships, and family corporations that own more than 97 percent of our nation's more than 2.1 million farms and ranches. Many farms and ranches are multi-generation businesses, with some having been in the family since the founding of our nation.

Many farmers and ranchers have benefited greatly from congressional action that increased the estate tax exemption to $5 million indexed for inflation, provided portability between spouses, and continued the stepped-up basis. Instead of spending money on life insurance and estate planning, most farmers are able to upgrade buildings and purchase equipment and livestock. And more importantly, they have been able to continue farming when a family member dies without having to sell land, livestock or equipment to pay the tax.

In spite of this much-appreciated relief, estate taxes are still a pressing problem for some agricultural producers. One reason is that the indexed estate tax exemption, now $5.49 million, is still catching up with recent increases in farmland values. While increases in cropland values have moderated over the last 3 years, cropland values remain high. On average cropland values are 62 percent higher than they were a decade ago. As a result, more farms and ranches now top the estate tax exemption. With 91 percent of farm and ranch assets illiquid, producers have few options when it comes to generating cash to pay the estate tax.

REDUCED TAXATION OF CAPITAL GAINS ENCOURAGES INVESTMENT

The impact of capital gains taxes on farming and ranching is significant. Production agriculture requires large investments in land and buildings that are held for long periods of time during which land values can more than triple. USDA survey data suggests about 40 percent of all family farms and ranches report some gain or loss, more than three times the average individual taxpayer. Farm Bureau supports reducing capital gains tax rates and wants an exclusion for farm land that remains in production.

Capital gains taxes are owed when farm or ranch land, buildings, breeding livestock and some timber are sold. While long-term capital gains are taxed at a lower rate than ordinary income to encourage investment and in recognition that long-term investments involve risk, the tax can still discourage property transfers or alternatively lead to a higher asking price.

Land and buildings typically account for 79 percent of farm or ranch assets. The current top capital gains tax is 20 percent. Because the capital gains tax applies to transfers, it provides an incentive to hold rather than sell land. This makes it harder for new farmers and producers who want to expand their business, say to include a child, to acquire property. It also reduces the flexibility farms and ranches need to adjust their business structures to maximize use of their capital.

STEPPED-UP BASIS REDUCES TAXES FOR THE NEXT GENERATION OF PRODUCERS

There is also interplay between estate taxes and capital gains taxes: stepped-up basis. Step-up sets the starting basis (value) of land and buildings at what the property is worth when it is inherited. Farm Bureau supports continuation of stepped-up basis.

Capital gains taxes on inherited assets are owed only when sold and only on gains over the stepped-up value. If capital gains taxes were imposed at death or if stepped-up basis were repealed, a new capital gains tax would be created and the implications of capital gains taxes as described above would be magnified. This is especially true for the vast majority of farmers and ranchers who are both under the estate tax exemption and have the benefit of stepped-up basis.

Stepped-up basis is also important to the financial management of farms and ranches that continue after the death of a family member. Not only are land and buildings eligible for stepped-up basis at death but so is equipment, livestock, stored grains, and stored feed. The new basis assigned to these assets resets depreciation schedules, providing farmers and ranchers with an expanded depreciation deduction.

LIKE-KIND EXCHANGES HELP AG PRODUCERS STAY COMPETITIVE

Like-kind exchanges help farmers and ranchers operate more efficient businesses by allowing them to defer taxes when they sell assets and purchase replacement property of a like-kind. Farm Bureau supports the continuation of Section 1031 like-kind exchanges.

Like-kind exchanges have existed since 1921 and are used by farmers and ranchers to exchange land and buildings, equipment, and breeding and production livestock.

Without like-kind exchanges some farmers and ranchers would need to incur debt in order to continue their farm or ranch businesses or, worse yet, delay mandatory improvements to maintain the financial viability of their farm or ranch.

FARMERS AND RANCHERS PAY SIGNIFICANT STATE AND LOCAL TAXES

Farm Bureau supports continuation of the deduction for state and local taxes. Loss of the deduction for state and local taxes paid would have a significant impact on farm and ranch businesses. According to the USDA Economic Research Service, state and local property taxes account for 16 percent of fixed expenses for all farms. An additional, important contributing factor is that taxes are often built into the price of rent and lease payments, which are substantial for farms. Therefore, losing the state and local tax deduction likely would cause higher rent and lease payments. It should be noted that the figures for taxes mentioned above are only for real estate and property taxes and do not include any state income taxes if those exist. Therefore, the overall local and state tax burden is likely higher than stated above.

SUMMARY

Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment, and entrepreneurship. We believe that the new code should be revenue-neutral and fair to farmers and ranchers. Tax reform should embrace the following overarching principles:

- Comprehensive: Tax reform should help all farm and ranch businesses, including sole proprietors, partnerships and sub-S corporations.
- Effective Tax Rate: Tax reform should reduce combined income and self-employment tax rates low enough to account for any deductions/credits lost due to base broadening.
- Cost Recovery: Tax reform should allow businesses to deduct expenses when incurred, including business interest expense. Cash accounting should continue. Section 1031 like kind exchanges should continue. There should be a deduction for state and local taxes.
- Estate Taxes: Tax reform should repeal estate taxes. Stepped-up basis should continue.
- Capital Gains Taxes: Tax reform should lower taxes on capital investments. Capital gains taxes should not be levied on transfers at death.

AMERICAN FOREST AND PAPER ASSOCIATION (AF&PA)

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The American Forest and Paper Association (AF&PA) serves to advance a sustainable U.S. pulp, paper, packaging, tissue, and wood products manufacturing industry through fact-based public policy and marketplace advocacy. AF&PA member companies make products essential for everyday life from renewable and recyclable resources and are committed to continuous improvement through the industry's sustainability initiative—Better Practices, Better Planet 2020.

U.S. manufacturers of paper and wood products appreciate the opportunity to provide input to the Senate Finance Committee as it considers how tax reform will grow our economy and create jobs across America. AF&PA supports comprehensive tax reform that encourages economic growth, job creation, and the competitiveness of all U.S. businesses. Central to this is a low corporate tax rate, support for investment in U.S. manufacturing and its global supply chain and a competitive territorial-based international tax system.

The U.S. forest products industry—made up of both C-corporations and pass-through entities—is a significant contributor to the U.S. economy, employing nearly 900,000 men and women in above-average wage jobs, investing heavily in equipment and improvements, and exporting products throughout the world. The U.S. forest products industry also supports jobs in other sectors of the U.S. economy. A recent study conducted by the Economic Policy Institute found that each paper industry job supports 3.25 jobs in supplier industries and in local communities as the result of respending and tax receipts.

The U.S. forest products industry provides excellent employee payroll, retirement, and health benefits to its workers. Meeting a payroll of approximately $50 billion, the forest products industry employs about the same number of people as the automotive industry and more people than the chemical and plastics industries. The industry has a generous compensation and benefits structure—earnings of pulp and paper mill workers exceed the average for all U.S. private sector workers by about 23 percent.

The industry produces more than $200 billion in paper and wood products annually, accounting for approximately 4.0 percent of the total U.S. manufacturing GDP, and ranks among the top 10 manufacturing sector employers in 45 states. In a typical year, the forest products industry transforms approximately 13 billion cubic feet of wood—the majority of which is purchased from privately-owned forest land—into value-added paper, packaging, lumber, and other wood products.

Our key goals include lowering the corporate tax rate and a reformed competitive international tax system to help attract and retain business operations and good paying jobs in the United States. To ensure capital-intensive manufacturers invest and expand with new and more efficient equipment, we support appropriate depreciation, interest expense, and research and experimentation tax policies. Further, capital gains and dividends rates for individuals should be tailored to ensure U.S. equity markets remain a reliable source of capital. AF&PA believes that a reformed tax code should be long-term, prospective, provide for a smooth transition, and not result in negative market bias.

We are highly capital-intensive, in some cases more so than the average manufacturing industry. Data from the U.S. Census Bureau's fourth quarter 2016 Quarterly Financial Report indicate that depreciation, depletion, and amortization amounted to 5.0 percent of paper industry sales, versus 3.2 percent for all manufacturing. The industry has made significant investments and facility upgrades in recent years. According to the Annual Survey of Manufacturers, in 2015, the paper and wood products industry invested $12 billion in plant and equipment. Items such as recovery boilers, turbine generators, paper machines, and environmental controls are critical to maintaining technologically advanced manufacturing facilities that compete in an extremely competitive global marketplace.

In addition to capital cost recovery issues, the tax provisions on net interest expense, employee benefits, and the deduction for pension, profit sharing, stock bonus, and annuity plans are important to our industry. Thus, we will be keenly monitoring developments and sharply focused on transition rules in these areas. In evaluating any tax reform proposals, we note that the lower the corporate rate, the less significant many of the tax attributes utilized by the industry become.

The industry's supply chain and customer base is globally integrated and includes many cross-border transactions. Exports of U.S. paper and wood products account for more than 15 percent of the industry's annual total sales. In 2016, the industry's global exports totaled $29.4 billion, of which $9 billion were exports of wood products and $20.4 billion were exports of pulp, paper and packaging. We estimate that our industry's exports support approximately 135,000 jobs at pulp, paper and wood products mills and related logging operations in the U.S., as well as many more jobs in communities where these facilities are located. At the same time, many of the industry's vital large capital purchases come from abroad because there is no U.S. manufacturer of like items.

AF&PA's member companies recognize that comprehensive tax reform will not be easy. However, the opportunity to increase U.S. economic growth through tax reform is enormous. We would be pleased to discuss these priorities with the committee and answer any questions you may have about our industry. We are eager for tax reform and appreciate the Finance Committee's attention to the issue.

For more information, please contact:

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BEER INSTITUTE ET AL.

September 19, 2018

The Honorable Orrin Hatch
Chairman

Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510–6200

Dear Chairman Hatch and Ranking Member Wyden:

As you convene a hearing today on Business Tax Reform, we are writing to express our support for excise tax reform for the beverage alcohol industry to be part of comprehensive tax reform which the Committee is considering.

Since its initial introduction in 2015, the Craft Beverage Modernization and Tax Reform Act (currently S. 236) has enjoyed overwhelming support in Congress. The legislation currently counts over 260 cosponsors in the House and nearly 50 in the Senate. Additionally, the bill has the support from a broad array of outside organizations, including the National Association of Manufacturers, and the American Farm Bureau. Even the National Taxpayers Union has described the Craft Beverage Bill as a "no brainer" bill that is "commonsense, bipartisan legislation that would in some way create a change for the better."

Every congressional district in the United States includes a brewery, winery, distillery, importer, or industry supplier. These businesses are often cornerstones of their communities. Unfortunately, outdated regulations and tax laws may impede the growth of these individual businesses.

The beverage alcohol industry remains one of the most regulated industries in America. Brewers, winemakers, and distillers pay state, local and federal taxes on their production. Federal excises taxes, which are regressive taxes, are simply too high. S. 236 would recalibrate and simplify federal excise taxes on domestic and imported beer, wine and spirits sold in the United States. It would also update and streamline outdated regulations.

The excise tax relief and regulatory reform embodied in S. 236 supports businesses of many shapes and sizes, both small and large. The broad, bipartisan, bicameral showing of support for this bill signifies how important excise tax relief is to many in Congress. We urge you to consider including S. 236 in any tax package that is slated for consideration in the 115th Congress and will stand with you to support its passage.

Sincerely,

Jim McGreevy, President and CEO
Beer Institute

Bob Pease, President and CEO
Brewers Association

Robert P. "Bobby" Koch, President and CEO
Wine Institute

Jim Trezise, President
WineAmerica

Mark Gorman, Senior Vice President
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Margie A.S. Lehrman, Executive Director
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Chairman Hatch, Ranking Member Wyden, and Members of the Committee, the Biotechnology Innovation Organization (BIO) applauds you for convening this hearing and for your dedication to reforming America's corporate tax code to make it competitive on the global stage.

BIO members are discovering groundbreaking cures and treatments for devastating diseases; developing advanced biofuels, renewable chemicals, and biobased products for the development of everyday innovative consumer products which simultaneously provide environmental benefits; and researching novel gene traits for identifying food sources that could help combat global hunger. As tax reform takes shape, it is imperative that Congress modernize the current U.S. corporate tax code, enabling America to maintain its leadership in these key 21st century industries in the face of challenges from foreign competitors.

For the United States to continue to lead the world in the 21st century innovation economy, tax reform must support the growth of small business innovators, incentivize investment in breakthrough technologies, and bolster U.S. companies currently hamstrung by a high corporate tax rate and a burdensome worldwide tax system out of step with the rest of the world.

The Impact of Tax Reform on Innovation

The tax code should recognize and promote innovation as fundamental to the long-term economic growth of the United States. Congress can take steps toward accomplishing this goal by including a specific section on innovation and entrepreneurship in any tax reform package. A standalone section of tax reform dedicated to the promotion of innovation would send a message to the world that the U.S. will not cede its global leadership while also ensuring that the drive to lower tax rates does not leave pre-revenue, emerging businesses behind.

BIO supports your efforts to streamline the tax code in order to facilitate lower rates and international competitiveness. At the same time, there are provisions in the current code that stimulate biotech R&D, and these provisions are vitally important to the scientific progress of BIO members. Furthermore, Congress has the opportunity in tax reform to take new steps to inspire innovative science by supporting the growth of, and incentivizing investment in, pre-revenue small businesses early in their life cycle. The combination of lower overall rates, strengthened innovation incentives, and targeted small business provisions will support breakthrough research and bolster the 21st century innovation economy.

In order to save lives, reduce dependence on foreign oil, build a biobased economy, and create jobs in innovative businesses, BIO believes the guiding principle of tax reform should be the promotion of innovation. BIO supports the following tax reform proposals, and believes they should be included in any reformed tax code.

International Tax Competitiveness

Lower Corporate Tax Rate

High tax rates impede America's ability to compete with other industrialized nations on the global stage, and our current corporate tax system stifles growth. The worldwide average tax rate has declined from 30 percent to 22.5 percent since 2003, with every region in the world seeing a decline in the average corporate tax rate in the previous 14 years. With international competitors gaining ground in the biotech industry, the U.S. cannot afford to continue this competitive imbalance. BIO supports efforts to lower the U.S. corporate tax rate to a competitive level.

To further bolster U.S. leadership in life sciences innovation, Congress also should consider favorable tax treatment of income derived from the research and manufacturing of innovative products in the United States. Such an approach should not affect the design of a competitive international tax regime or treat income derived from intangible assets less favorably than other income.

Territorial Tax System

It is vital that Congress take steps to move America to a competitive territorial tax system, unburdened by overly stringent anti-base erosion policies and consistent with those in so many other OECD countries. Freeing up over two trillion dollars that are currently trapped overseas due to the inefficiencies of the tax code will boost economic growth and capital investment.

Congress should ensure that a move to a territorial system is truly competitive for knowledge-based industries like biotechnology. Placing disproportionate tax burdens on the biotechnology industry harms America's competitiveness on the world stage and could stymie cutting-edge R&D critical to meeting our nation's public health, agricultural, bioenergy, and environmental challenges.

Existing Tax Incentives for Innovation

R&D Tax Credit

BIO supports maintaining the R&D Tax Credit in the reformed tax code, while at the same time strengthening it by increasing the Alternative Simplified Credit (ASC) rate. The R&D Credit was made permanent by the Protecting Americans from Tax Hikes (PATH) Act in December 2015, and BIO strongly believes it should remain in the reformed tax code. Studies have shown that the R&D Tax Credit contributes to U.S. job growth and an increase in the U.S. GDP. However, the U.S. has fallen behind in its R&D incentive generosity, falling from a leader among OECD countries in the late 1980s to 25th for large companies and 26th for small businesses in 2016. Maintaining and strengthening this credit would recognize its vital role in supporting America's innovation economy.

PATH Act R&D Credit Reforms

BIO also supports maintaining the PATH Act's reform to the R&D Tax Credit that allows pre-revenue innovators to take a portion of their Credit against their payroll tax obligation, an important recognition that income tax credits do not yet benefit pre-revenue companies.

Under current law, companies in their first 5 years of operation can utilize up to $250,000 in R&D Credits under the PATH Act reforms. While BIO believes this change was an important first step, we would also support expanding the provision, either by extending the eligibility time period or by expanding the dollar amount of credits available for use. Given the long development timelines of groundbreaking innovation and the high costs of biotech research, these targeted expansions to the payroll credit would ensure that innovative pre-revenue companies can take full advantage of this new incentive.

Orphan Drug Tax Credit

BIO supports maintaining the Orphan Drug Tax Credit in the reformed tax code. The Credit, which was enacted in 1983 and made permanent in 1997, corrects a market failure by removing significant impediments to drug development for rare diseases that do not exist for diseases with larger patient populations.

By reducing the costs of developing drugs for smaller patient populations, the Orphan Drug Tax Credit has encouraged companies to develop hundreds of new therapies that would otherwise not have been commercially feasible. Since its enactment, there have been over 600 drugs developed to treat more than 400 rare diseases. According to recent studies, a third of the existing treatments approved for orphan indications would not have been developed if not for the Orphan Drug Tax Credit.

By maintaining the Orphan Drug Tax Credit in the reformed tax code, Congress can ensure that the Credit will continue to incentivize the development of drugs to treat rare diseases for which no treatment currently exists—helping millions of patients suffering from rare conditions get the new medicines they desperately need, while fostering economic growth through new and expanding biotech companies with good jobs and high wages.

Small Business Tax Incentives

By itself, a lower corporate tax rate will not support growth and innovation in America's small businesses, many of which are pre-revenue. Comprehensive tax reform should go further than "broadening the base and lowering the rate." Instead, policymakers should specifically promote innovative research-intensive businesses through incentives for other companies, individuals, and funds to invest in small companies and support their research.

Section 469 R&D Partnership Structures

Prior to 1986 tax reform, many growing companies attracted investors by using R&D Limited Partnerships, in which individual investors would finance R&D projects and then utilize the operating losses and tax credits generated during the research process. These structures gave investors a tax incentive to support biotech research, which is entirely dependent on outside investors but often too risky or expensive to attract sufficient investment capital. The enactment of the passive activity loss (PAL) rules in 1986 prevented investors from using a company's losses to offset their other income, thus removing the incentive to support vital research.

BIO supports targeted reforms to Section 469 to allow a limited exception from the PAL rules for R&D-focused pass-thru entities. Under this proposal, small companies would be able to enter into a joint venture with an R&D project's investors. The losses and credits generated by the project would then flow through to the company and investors, who would be able to use the tax assets to offset other income. Relaxing the PAL rules to allow investors to enjoy a more immediate return on their investment, despite the long and risky timeline usually associated with groundbreaking research, would incentivize them to invest at an earlier stage, when the capital is most needed.

This proposal has been introduced on a bipartisan basis in both the House and the Senate. In the 114th Congress, Senators Toomey, Menendez, Roberts, and Carper introduced the Start up Jobs and Innovation Act, which would make this vital reform in order to spur investment in early-stage groundbreaking innovation.

Innovation Investor Tax Credit

Providing a tax credit for individual investors who support research at its earliest stages could lead to a capital infusion for the small business innovators at the forefront of scientific advancement. In the biotech industry, emerging companies are developing 70% of the global pipeline—including 84% of the industry's product candidates to treat rare diseases. The vast majority of these clinical programs are still in early-stage research (only 16% have made it to Phase III clinical testing), so continued investor support is vital to bring these potentially life-saving treatments out of the lab, bring them through the clinic, and ultimately deliver them to patients in need.

A tax credit targeted at early-stage investors in innovative industries would incentivize the capital infusion necessary to fund 21st century R&D. In biotechnology, and other innovative industries, early-stage funding is key to a company's success. Without product revenue for more than a decade, these small businesses depend on investor capital to fund their research into life-saving treatments and groundbreaking technologies. A targeted tax credit, designed to stimulate early-stage capital, would serve as an important incentive for investment in the R&D at the foundation of America's innovation economy.

Section 382 NOL Reform

Innovative companies often have a long and capital-intensive development period, meaning that they can undergo a decade of research and development without any product revenue prior to commercialization. During this time period, companies generate significant net operating losses (NOLs), which can be used to offset future gains if the company becomes profitable. However, Section 382 restricts the usage of NOLs by companies that have undergone an "ownership change." The law was enacted to prevent NOL trafficking, but small biotech companies are caught in its scope—their reliance on outside financing and deals triggers the ownership change restrictions and their NOLs are rendered useless.

BIO supports reform of Section 382 to allow certain NOLs to be carried forward at companies conducting R&D or in the event of a capital infusion or financing round. This change would allow small companies the freedom to raise capital for innovative research without fear of losing their valuable NOLs. Additionally, the ability of a small business to maintain its NOLs makes it more attractive to investors and purchasers looking to take its research to the next level.

Section 1202 Capital Gains Reform

Section 1202 allows investors to exclude from taxation 100% of their gain from the sale of a qualified small business (QSB) stock if they hold the stock for five years. This provision was designed to promote investment in growing businesses, but its overly restrictive size requirements prohibit innovative companies from accessing valuable investment capital. Currently, QSBs must have gross assets below $50 million. The high costs of research, coupled with valuable intellectual property and successive rounds of venture financing, often push growing innovators over the $50 million gross assets limit and out of the QSB definition.

In addition to maintaining the 100% exclusion, BIO supports changing the QSB definition to include companies with gross assets up to $150 million, with that cap indexed to inflation. BIO also supports excluding the value of a company's IP when calculating its gross assets. These changes would allow more growing innovators to attract investors to fund their vital research. Providing incentives to invest in biotech research will increase the innovation capital available to research-intensive businesses and speed the development of groundbreaking medicines.

Biofuels Tax Incentives

Since 2009, the advanced biofuels industry has invested billions of dollars to build first-of-a-kind demonstration and commercial-scale biorefineries across the country. Despite the challenges associated with developing new technologies, as of 2015 there were five commercial scale cellulosic biorefineries with a combined capacity of more than 50 million gallons within the United States. Unfortunately, policy instability undermines certainty and predictability for investors and other market participants. The uncertain cycle of expirations and reinstatements for tax incentives for advanced and cellulosic biofuels make it difficult for the industry to take advantage of these tax incentives that could help move these projects to commercial production by attracting investment and reducing the cost of production.

The development of advanced and cellulosic biofuels is a difficult and capital-intensive enterprise. Despite the recent successes of building commercial-scale facilities, this is a new and developing industry. However, there are great benefits to developing these technologies. Over the past 10 years the biofuels industry has displaced nearly 1.9 billion barrels of foreign oil by replacing fossil fuels with homegrown biofuels. This has saved consumers an average of $1 a gallon at the pump. The use of biofuels has also led to a reduction in U.S. transportation-related carbon emissions of 590 million metric tons over the past decade—an equivalent of removing more than 124 million cars from the road. Even with these benefits, this sector needs predictable federal tax policy to continue to attract investment in order to grow and compete with incumbent industries that have long received favorable tax preferences.

Tax Incentives for Biofuel Innovation

BIO has long supported a suite of tax incentives important for the development of advanced and cellulosic biofuels—the Second Generation Biofuel Producer Tax Credit (PTC), the Special Depreciation Allowance for Second Generation Biofuel Plant Property, the Biodiesel and Renewable Diesel Fuels Credit, and the Alternative Fuel Vehicle Refueling Property Credit. Unfortunately, the PTC and associated depreciation provisions have never been enacted for a sufficient length of time to allow investors to depend upon their existence once the facilities are eventually placed in service. BIO supports the extension of these provisions. Further, BIO would encourage Congress to reject the creation of a phase-out. Ending the tax credits on an arbitrary date in the near term will hamper the utilization of these incentives for an industry where financing and constructing new facilities takes on average 5 to 6 years.

Clean Energy Development

If the Committee determines it could best stimulate investment and growth of clean energy development and deployment with a simple, durable, and technology neutral program, it is important the Committee develops a formula that does not inadvertently discriminate against technologies. BIO strongly supports the concept of providing tax incentives on a performance basis rather than arbitrary assignment by statute. With any energy efficiency formula, it may be necessary to provide some extra bonus credits to fuels that achieve a "negative" carbon emissions rating and to fuels that provide socially valuable octane enhancements. BIO believes Ranking Member Wyden's Clean Energy for America Act (S. 1086) is one technology neutral proposal which could stimulate investment into and growth of biofuels and other forms of clean energy.

Tax Incentive Eligibility

Technology neutral incentives must also provide developers and investors confidence in the availability of the tax incentives. The Department of Treasury process that determines eligibility of fuels should rely wherever possible upon existing Environmental Protection Agency (EPA) data. However, due to lengthy and unpredictable administrative processes with EPA approval of pathways, which would undermine public confidence in the timely availability of the incentives, BIO suggests that EPA should be encouraged to provide interim data wherever possible that would allow the fuels to become eligible for tax incentives in advance of the multi-year pathway determinations.

To allow for a smooth transition to the new credit program, the definition of "qualifying facility" should be adjusted to provide a uniform 10-year stream of production tax credits for each otherwise eligible facility placed in service before date of enactment. Facilities placed in service after date of enactment would trigger the 10-year period when placed in service. We would like to continue to work with Members of Congress to develop a tax incentive regime for advanced and cellulosic biofuels that reflects the life cycle environmental benefits of those fuels.

Funding for Infrastructure Investment

Should the Committee consider an increase to the excise tax on gasoline to fund infrastructure developments and provide greater funding for highways, which could increase the number of construction and manufacturing jobs in the economy, BIO encourages the Committee to carefully balance incentives to develop innovative biofuels and the necessary distribution infrastructure. Any future increases to the excise tax on gasoline should include a reduced rate for fuels that contain higher levels of ethanol and other biofuels, ranging from E15, which contains 15 percent ethanol, up to E85, which contains 85 percent ethanol. A rate reduction for higher blends of biofuels in the transportation fuel supply will spur greater use of domestically produced renewable fuel. Providing a lower excise tax on fuels containing higher levels of ethanol will spur investments in infrastructure to deploy greater volumes of biofuels and grow market space for advanced and cellulosic biofuels. This will benefit consumers, the nation's economy, infrastructure, rural communities, and energy and national security.

Renewable Chemicals and Biobased Products Tax Incentives

Companies are using industrial biotechnologies to help resolve important challenges in synthesizing new products, whole cell systems, and other biological processes to improve all types of manufacturing and chemical processes. This progress is enabling the production of a new generation of renewable chemicals, biobased products, and bioplastics produced from renewable biomass, which can supplement or substitute for traditional petroleum-based chemicals and products. Given that the U.S. faces the challenge of reducing its costly dependence on foreign oil and competing in a $2.4 trillion worldwide clean energy market with a number of countries already implementing aggressive alternative energy development programs, the emergence of this technology represents a historic opportunity to reverse job losses in the U.S. chemicals and plastics sectors while simultaneously improving energy security and the environment.

Investment and production tax credits are currently offered to incumbent fossil energy industries. As such, tax incentives for renewable chemicals and biobased products are critical to our efforts to attract capital given that these types of incentives are offered to other U.S. energy sectors. It will be more difficult for renewable chemical companies to develop projects in the United States if other nations such as China, Germany, Malaysia, and other BRIC nations offer attractive investment incentives. To realize the industry's potential for domestic job creation and reduced reliance on foreign oil, Congress must ensure that renewable chemical technologies are incentivized in the tax code, and at a minimum receive tax parity with other renewable energy technologies.

Production or Investment Tax Credit for Qualifying Renewable Chemicals

BIO supports the enactment of a production or investment renewable chemicals tax credit, which would create a targeted, short-term tax credit for the production of qualifying renewable chemicals from biomass. Applicants for the tax credit would be evaluated on job creation, innovation, environment al benefits, commercial viability and contribution to U.S. energy independence. Like current law for renewable electricity production credits, the credits would be general business credits available for a limited period per facility. This renewable chemicals tax credit would support innovation and help domestic companies compete in a rapidly growing global renewable chemicals market, revitalize domestic manufacturing, and bring new energy efficient biobased products for consumers. That, in turn, would create millions of new jobs and opportunities for economic growth.

To truly achieve energy security, the U.S. must develop biorefineries that produce alternatives to all of the products made from each barrel of oil. Industrial biotechnology enables the production of renewable chemicals and biobased products from biomass, and the total displacement of fossil fuel products can be accelerated with a production or investment tax credit. The bipartisan reintroduction of the Renewable Chemicals Act (H.R. 3149), offers a strong model for implementation of this proposal.

Master Limited Partnerships Parity Act for Renewable Chemicals and Biofuel Producers

BIO supports the Master Limited Partnerships Parity Act, previously introduced in the 113th and 114th Congresses, which would extend the publicly-traded partnership ownership structure to renewable energy power generation projects, renewable chemicals, and transportation fuels. This bill would amend the Internal Revenue Code to extend availability of the master limited partnership (MLP) business structure in which renewable chemicals and biofuels investors are treated as partners for tax purposes but whose ownership interest can be traded like corporate stock. Availability of the MLP structure would reduce the cost of private capital for renewable chemicals and biofuels projects. BIO supports this important effort to modernize MLP, which is extremely timely given the significant transformation in the nation's energy mix that has occurred over the past two decades.

Reinstating Sec. 48C and Eligibility for Renewable Chemicals and Biobased Products

To realize the full potential of the domestic renewable chemicals industry, existing renewable energy and manufacturing tax incentive regimes should be opened to renewable chemicals. Renewable chemicals and biobased products impact everyday products impacting our economy, such as car parts, cleaning products, soaps, insulation materials, plastics, foams, fibers, and fabrics. BIO urges Congress to incorporate the language of the Make It in America Tax Credit Act of 2011 into any energy or manufacturing tax package discussed and introduced in tax reform.

Conclusion

Federal tax policy that recognizes the special demands placed on biotech companies and other highly innovative industries will speed the development of products to vastly improve the lives of Americans and people around the world. By recognizing the importance of innovation and the economic potential of the biotech industry, Congress can incentivize further development and improve America's economic health.

BIO supports a U.S. tax code that recognizes innovation as a crucial part of the 21st century American economy and encourages innovative research and new technologies to enter the market. The tax code should promote research-intensive and advanced manufacturing businesses as they continue to create high-quality American jobs, stimulate long-term economic growth, and bolster America's competitiveness on an increasingly global stage.

BUILD COALITION
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September 18, 2017

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

The Honorable Ron Wyden
Ranking Member
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
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RE: Senate Finance Committee hearing on "Business Tax Reform" (September 19, 2017) and the preservation of full interest deductibility

Dear Chairman Hatch, Ranking Member Wyden, and Members of the Committee:

The Businesses United for Interest and Loan Deductibility (BUILD) Coalition is submitting this letter to reiterate our support for maintaining full interest deductibility in tax reform. We applaud the Committee's thoughtful approach to making tax reform a legislative priority, and we support its commitment to simplifying the code, creating a system that treats all taxpayers equally, and fostering sustained economic growth in today's competitive global marketplace.

The BUILD Coalition's members represent critical industries throughout the American economy, including agriculture, manufacturing, real estate, retail, and telecommunications. We believe that any measures to spur long-term, sustainable U.S. economic growth should ensure companies retain the necessary access to affordable capital for undertaking new investments, expanding operations, and creating more jobs.

Therefore, as the Committee determines which of the various elements of the tax code should remain or be reformed to encourage stronger growth, we'd like to reinforce the importance of preserving the full deductibility of interest on borrowing for all U.S. businesses. To create a tax structure that fulfills America's maximum growth potential, Congress must avoid any limitation to, or elimination of, interest deductibility.

Our experience managing the daily operations of our respective businesses compels us to relay the real-world implications of eliminating or limiting interest deductibility. It is also essential that we dispel misconceptions regarding this key part of our tax code, including the inaccurate notions that limiting, interest deductibility to finance a lower tax rate for businesses would result in economic growth, that the interest expense deduction distorts financing decisions, that interest deductibility can be replaced by immediate expensing of capital expenditures, and that interest deductibility encourages excessive risk in the economy.

The deductibility of business interest expense is a well-established, growth-promoting component of the tax code. Interest expense is a normal cost of doing business. The deduction for interest is necessary to measure income properly and has been present in the tax code since the implementation of the modern income tax structure roughly a century ago. Failure to maintain interest deductibility will overstate a business' taxable income and result in over-taxation. By guaranteeing businesses will not be taxed on the cost of accessing capital, interest deductibility affords us the correct tax treatment and encourages us to continue to invest in growing our businesses and creating more jobs.

Also, a study by Ernst and Young (EY) finds that limiting interest deductibility to help fund a lower corporate tax rate would negatively impact economic growth in the long-run.[1] More specifically, EY found that a 25 percent across-the-board limitation on corporate interest expenses can be used to fund an approximate 1.5 percentage-point reduction in the corporate income tax rate. EY's research found that this trade-off would raise the cost of capital and result in a decline in long-run GDP of 0.2 percent, with the majority of this effect occurring in the first 10 years.

In other words, proposals that call for placing limits on interest deductibility in order to achieve a lower tax rate for businesses run counter to the Committee's stated goal of achieving pro-growth tax reform.

Beyond economic models, the practical implications of limiting or eliminating interest deductibility for businesses throughout the U.S. economy raise major cause for concern. As our member organizations prove, businesses of all sizes borrow in order to finance expansions or meet obligations and the ability to deduct interest expense gives business owners the certainty to make critical operating decisions. For many firms, access to credit is essential for working capital, and many of these companies use debt to weather shifts in demand.

Our nation's debt capital markets are the most liquid and efficient in the world. Banks supply the credit that is in turn the life blood of American businesses of all sizes and types-the businesses that provide the core growth in our economy.

The impact would be particularly harsh for startups, small businesses, and other private companies, which do not have ready access to alternative sources of financing. In fact, research has found that 75 percent of startups and 80 percent of small businesses rely on debt financing.[2] In addition to these small businesses, medium and large enterprises also turn to debt financing in large part because of its efficiency and relative speed to market compared to equity financing. Borrowing allows these businesses to respond quickly to market demands and capitalize on new opportunities, whether through revolving lines of credit, bonds, or bank loans. Without access to affordable credit, companies of all sizes will struggle to create jobs and grow the economy.

Proponents of eliminating interest deductibility argue that the tax code favors debt over equity, and that this encourages companies to take on more leverage. And yet, research by economists from Duke University, University of Pennsylvania, and Washington University in St. Louis,[3] as well as findings by Nobel Prize-winning economist Merton Miller,[4] show that the tax code has little to no impact on companies' leverage ratios. Harvard University finance professor Mihir Desai confirmed the findings of these earlier studies, noting that the non-financial sector is "remarkably underlevered by historical standards."[5] We believe this is because corporate decisions regarding the level of debt to assume are impacted by numerous non-tax market forces, such as analysts, rating agencies, regulators, investors, and lenders.

Moreover, the argument that equity and debt financing are similar is a fallacy. Debt and equity do not serve identical purposes and are not interchangeable forms of financing. There are a variety of non-tax reasons that businesses like ours choose debt over equity when raising capital. Thus, their differing tax treatment is appropriate.

[1] EY's Quantitative Economics and Statistics (QUEST) Group. "Macroeconomic Analysis of a Revenue-Neutral Reduction in the Corporate Income Tax Rate Financed by an Across-the-Board Limitation on Corporate Interest Expenses." EY. July 2013.

[2] Cole, Rebel A., "Why Businesses Use Debt—And How Debt Benefits Businesses." June 2013.

[3] Graham, John R., Mark T. Leary, and Michael R: Roberts. "A Century of Capital Structure: The Leveraging of Corporate America." June 2014.

[4] Miller, Merton. "Debt And Taxes." *Journal of Finance.* May 1977.

[5] Desai, Mihir. Testimony of Mihir A. Desai. United States Senate Committee on Finance and the United States Committee on Ways and Means. July 2011.

For one thing, many businesses do not have access to equity markets, making debt their only option to start and grow enterprises that in turn create new jobs. In contrast to the dilutive effects of equity, borrowing allows owners to access capital without diluting control of their business. Debt is also a cheaper financing solution than equity because it is more secure for investors, who charge a premium for the risks associated with equity. Therefore, on both sides of the equation, debt and equity play separate and distinct roles in capital formation.

To the extent that policymakers would like to incentivize equity financing, the answer is to reduce or eliminate the tax on dividends, not to punish and restrict debt financing by removing or limiting interest deductibility. Any purported debt bias would also be significantly reduced by lowering the corporate tax rate.

In addition, proposals to offer 100 percent expensing in place of interest deductibility miss the mark. Such proposals fail to account for the real-life implications of what such a trade-off means for businesses, namely that full and immediate capital expensing is not an acceptable alternative for interest deductibility. Immediate expensing is a timing difference, while interest deductibility has a permanent impact and helps ensure income is properly measured.

A recent analysis by Goldman Sachs Economics Research predicts that proposals to eliminate interest deductibility in favor of 100 percent expensing "would raise the user cost of capital and reduce investment in the longer run." While 100 percent expensing might boost cash flows in the near term by pulling forward depreciation schedules, "after the first year, however, the impact on cash flow would begin to decline and eventually turn negative," the Goldman Sachs study warns.[6]

These harmful effects would not be canceled out by lower rates, either. As University of Pennsylvania professor Chris Sanchirico has explained, even proposals to lower the tax rate would "not temper" the harmful effects of the proposed trade-off between interest deductibility and expensing.[7] As businesses that make these financing decisions every day, we know firsthand that you can't expense what you can't afford.

Lastly, some have claimed that debt inherently creates risk in the economy and that steps should be taken to discourage too much borrowing by businesses. This is by no means a given. In fact, a study published by the St. Louis Federal Reserve's Brent Glover, Joao F. Gomes, and Amir Yaron finds that limiting interest deductibility would actually *increase* volatility throughout the economy by raising the overall cost of accessing capital. The authors understand that limiting or eliminating the deduction for business interest expense would push firms to intentionally cap their size and rely more on operating leverage, making them more susceptible to default.

Glover, Gomes, and Yaron conclude: "Contrary to conventional wisdom, we find that eliminating interest deductibility results in an increase in the default frequency and average credit spreads. The intuition for this lies in the fact that this policy change makes external financing more costly, which results in riskier firms and higher credit spreads."[8]

All of the arguments against interest deductibility also ignore the distributional impact of limiting interest deductibility. According to a report by the Small Business Administration (SBA), woman- and minority-owned small businesses typically have less access to equity markets compared to other businesses. Thus, woman- and minority-owned small businesses turn to bank loans, as well as alternative lending methods. By limiting interest deductibility, policymakers would further increase the existing financial burdens that woman and minority business owners face when trying to raise capital for investments.[9]

These are just the immediate dangers. Numerous policy proposals would also suffer if interest deductibility is limited. For example, President Donald Trump has announced his desire for a $1 trillion infrastructure investment plan based in large part on public-private partnerships. Congressional leaders have discussed similar proposals, which also feature a heavy emphasis on the private sector. Of course, lim-

[6] Mericle, David, and Daan Struyven. "U.S. Daily: Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing." Goldman Sachs Economic Research. November 2016.

[7] Sanchirico, Chris William. "Expensing and Interest in the GOP Blueprint: Good Deal? Good Idea?" *Tax Notes.* April 2017.

[8] Glover, Brent, Joao F. Gomes, and Amir Yarons. "Corporate Taxes, Leverage, and Business Cycles." St. Louis Fed. July 2011.

[9] Robb, Alicia. "Access to Capital Among Young Firms, Minority-owned Firms, Women-owned Firms, and High-tech Firms." U.S. Small Business Administration. April 2013.

iting or eliminating the deductibility of interest expense would undermine these plans by increasing the cost of capital and making such investments less feasible for the private sector.

Finally, limiting interest deductibility would directly undermine "America-First" goals for tax reform. America's capital markets are second to none, giving the U.S. a major advantage over other nations in attracting businesses and investment. Without the ability to deduct interest expenses, these businesses would look overseas for their credit needs, weakening U.S. credit markets and hindering job growth.

As the Committee investigates ways to promote stronger economic growth and faster job creation through tax reform, it must maintain provisions in the tax code that help achieve these goals. Interest deductibility is one of these provisions, and has been since the creation of the modern tax code.

While the BUILD Coalition fully supports the Committee's goal of achieving pro-growth tax reform, any proposal that places limitations on interest deductibility will harm these efforts. We strongly encourage the Committee, in any proposed tax legislation, to maintain the full deductibility of business interest expense as it exists under current law. By doing so, policymakers will give the U.S. economy the opportunity to achieve its full growth potential.

Sincerely,
The BUILD Coalition

Business Roundtable

The nation's tax system is in urgent need of reform to boost economic growth, increase global competitiveness for American companies, and bring about meaningful improvements in the incomes of American families through higher wages and more American jobs.

It has been over 30 years since Congress last undertook tax reform. The United States has failed to act while the rest of the world has implemented modern tax policies to aggressively compete for jobs and investment. The urgency of tax reform cannot be overstated.

Tax reform, done right, will be a catalyst for U.S. economic growth, increased wages and job creation. A recent Business Roundtable survey found that CEOs believe that tax reform is the single most effective action that Congress can take to accelerate economic growth. Seventy-six percent of the CEOs said that they would increase hiring at their company if tax reform is enacted, and 82 percent would increase capital spending.

Comprehensive tax reform for both individuals and businesses—including more competitive rates for non-corporate businesses—is fundamental to strengthening the U.S. economy, enhancing job creation, increasing wage growth, and ensuring that American workers and American companies can successfully compete around the globe. Tax reform should also be used to give a targeted boost to lower- and middle-income workers by expanding programs such as the Earned Income Tax Credit (EITC), which already provides a helping hand to more than 29 million workers.

A comprehensive approach is the best way to create a modern, competitive tax system for both businesses and individuals. Business Roundtable calls for the following corporate tax changes:

- A corporate tax rate set at an internationally competitive level; and
- A modern international tax system (territorial-like) that permanently removes the penalty for returning foreign earnings to the United States, thereby aligning the U.S. system with the tax systems of our major trading partners.

We believe that these reforms can be achieved in a fair and fiscally responsible manner. Business Roundtable companies are committed to putting all corporate tax credits and special deductions on the table in consideration of an internationally competitive corporate tax system.

Based on the knowledge and experience of most Business Roundtable CEOs, the remainder of this submission focuses on reform of the corporate income tax system.

The Need for U.S. Corporate Tax Reform

The U.S. corporate tax system was last reformed in 1986. It is outdated and fails to reflect the increased competition American companies face from their global competitors both at home and abroad. The U.S. corporate tax rate is the highest among industrialized countries. Including state taxes, the combined U.S. statutory corporate tax rate is 38.91 percent, more than 15 percentage points higher than the 23.75 percent average combined national and sub-national statutory corporate tax rate of the other 34 members of the Organization for Economic Cooperation and Development.[1]

While effective tax rates are typically lower than statutory tax rates, U.S. effective tax rates are consistently found to be among the highest of developed countries. A recent study conducted for the European Commission found the corporate effective marginal tax rate for investments in the United States to be 34.3 percent while the average of the other 34 surveyed countries (28 EU countries, plus four other European countries, Canada, and Japan) was 16.0 percent.[2] Many other developed countries also have special favorable tax rules for intellectual property, including so-called "patent boxes" or "innovation boxes," with effective tax rates on such income typically ranging from 5 to 15 percent.[3]

Further, the U.S. international tax system still is premised on rules first adopted in 1909 that tax the worldwide income of American corporations. Virtually all other advanced economies—including all other G7 countries and 29 of the other 34 OECD countries—have adopted territorial tax rules that ensure that their own companies are as competitive as possible in the global market place. By contrast, the U.S. rules place an additional tax on the foreign earnings of U.S. companies when they are sent home, which discourages the repatriation of these earnings and has now resulted in $2.6 trillion in foreign earnings being trapped overseas due to America's anticompetitive tax system.

Together, the high U.S. corporate tax rate and outdated international tax rules make the U.S. corporate tax system an outlier from the rest of the world, harming the ability of American companies and their workers to compete successfully. By suppressing investment in the United States, the corporate income tax lowers worker productivity and holds back wages. An estimated 75 percent of the corporate income tax burden falls on workers.[4]

Successful tax reform should end the competitive tax disadvantage that U.S. companies and American workers face every day in the global marketplace.

Creating a Competitive Advantage

Our trading partners use their corporate tax systems to achieve competitive advantage at the expense of the American worker. For example, Canada has aggressively lowered its combined federal and provincial corporate tax rate from 42.4 percent to 26.7 percent since 2000, with the federal rate now at 15 percent. As outlined by the Canadian government in a 2006 policy document, "Advantage Canada," this was part of an explicit Canadian policy to obtain a competitive advantage over the United States:

> To create a Canadian tax advantage over the coming years, Canada's New Government will . . . [e]stablish a broader corporate tax advantage for Canada in the treatment of business investment. Step one is to create a meaningful tax advantage over the United States, our closest economic partner. Step two is to achieve the lowest tax rate on new business investment in G7 countries.[5]

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[1] OECD Tax Database, available at: *http://stats.oecd.org/Index.aspx?DataSetCode=TABLE_II1.* The average U.S. state corporate tax rate is 6.01 percent according to the OECD. Because state corporate income taxes are deductible against federal corporate income taxes, the combined federal and state statutory corporate tax rate is .35 + (1 − .35)(.0601) = 38.91 percent. If tax reform lowered the U.S. federal corporate tax rate to 20 percent, it would result in a combined federal and state tax rate of 24.81 percent—still a full percentage point greater than the OECD average rate.

[2] Center for European Economic Research (ZEW), "Effective Tax Levels Using the Devereux/Griffith Methodology," Project for the EU Commission TAXUD/2013/CC/120, Intermediate Report, October 2015, available at: *http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/common/publications/studies/effective_tax_rates.pdf.*

[3] Countries with patent or innovation boxes include Belgium, France, Hungary, Ireland, Israel, Italy, Korea, Luxembourg, Malta, Netherlands, Portugal, Spain, Switzerland, Turkey, and the United Kingdom. For details on qualifying income and tax rates, *see* PwC, Global Research and Development Incentives Group, April 2017, available at: *https://www.pwc.com/gx/en/services/tax/international-tax-services/global-research-and-development-incentives-group.html.*

[4] For example, a study by the Congressional Budget Office concludes that 73.7 percent of the burden of the corporate income tax is borne by workers. *See,* Congressional Budget Office, "International Burdens of the Corporate Income Tax," August 2006.

[5] "Advantage Canada: Building a Strong Economy for Canadians," Department of Finance Canada, p. 33, available at: *https://www.fin.gc.ca/ec2006/pdf/plane.pdf.*

Since 2000, average wages have grown 7 percent faster in Canada than in the United States.[6] And even with the substantially lower tax rate, Canada's federal corporate tax revenues as a share of GDP are greater than those of the United States and greater than in the 1980s when Canada's federal tax rate was twice as high.[7]

Perhaps not surprisingly, Canada understands U.S. tax reform can end Canada's tax advantage and attract greater investment to the United States.[8]

The problem for the United States has been that nearly every developed country has explicitly or implicitly sought to achieve a tax advantage over the United States. Of the other 34 OECD countries, all but one have lowered their statutory corporate tax rate since the last U.S. tax reform—and all have set their corporate tax rate below that of the United States.

At the same time, territorial tax systems—under which a company pays tax in the country in which profits are earned but not a second time when earnings are brought home to the company's home country—have become the norm among developed countries. Since 1990, the number of OECD countries with territorial tax systems has grown from 9 to 29.[9] Of the 29 countries, 21 provide 100 percent exemption for foreign qualifying dividends and the other 8 exempt 95 to 97 percent of such income, resulting in a home-country tax rate of approximately 1 percent on the foreign dividend.

U.S. companies operate in an increasingly competitive global market place. Among companies listed in the Global Fortune 500, the number of U.S.-headquartered companies declined by 25 percent between 2000 and 2015. U.S. companies competing abroad are virtually certain to be facing competition from a company headquartered in a territorial country in addition to locally headquartered companies that face only the local country tax.

Both a competitive U.S. corporate tax rate and adoption of a modern international tax system can turn the current U.S. tax disadvantage into a U.S. tax advantage. With a competitive 20 percent corporate tax rate, a new study for Business Roundtable estimates that 4,700 companies would have remained under U.S. ownership over the past 13 years.[10]

The Framework for a Competitive U.S. Corporate Tax System

Current high tax rates discourage investment and hold back wages and job creation in the United States. Further, the current U.S. international tax rules hinder American companies in foreign markets and discourage them from bringing their earnings home for reinvestment.

Business Roundtable believes that reform should include reduction of the corporate tax rate to a competitive level, taking into consideration both federal and state corporate tax rates. Additionally, tax reform should include adoption of a modern international tax system, consistent with the territorial tax systems of our major trading partners, to allow U.S. companies to compete on a level playing field with their foreign competitors and return their foreign earnings for investment in the U.S. economy.

We also believe these goals can be achieved in a fiscally responsible manner, taking into account the positive macroeconomic benefits from tax reform and a realistic

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[6] OECD statistics, available at: *https://stats.oecd.org/Index.aspx?DataSetCode=AV_AN_WAGE.*

[7] *See,* Fiscal References, Table 4, providing historical data on Canadian federal tax revenues, available at: *http://www.fin.gc.ca/frt-trf/2016/frt-trf-16-eng.pdf.*

[8] *See* recent articles in the Canadian press describing the potentially adverse impact of U.S. corporate tax reform on Canada's current tax advantage as well as the benefits to the United States: "Donald Trump's 'big, big' corporate tax cut could 'erase Canada's advantage'," *Global News,* March 1, 2017; *(http://globalnews.ca/news/3279987/donald-trump-corporate-tax-cut-canada/);* "Trump's corporate tax cut could end Canada's advantage," *Toronto Star,* April 26, 2017 *(https://www.thestar.com/business/2017/04/26/trumps-corporate-tax-cut-could-end-canadas-advantage.html);* "'A real negative for Canada': Businesses warn Trump's tax plan would hurt competitiveness," *National Post,* April 27, 2017 (*http://business.financialpost.com/news/economy/a-real-negative-for-canada-businesses-warns-trumps-tax-cut-plan-would-hurt-competitiveness/wcm/cOddad77-5698-44b4-8f15-5ac67c9bb059).*

[9] PwC, "Evolution of Territorial Tax Systems in the OECD," prepared for the Technology CEO Council, April 2013; updated for accession of Latvia to the OECD in 2016, and Latvia's adoption of territorial rules in 2013.

[10] EY, "Buying and Selling: Cross-Border Mergers and Acquisitions, and the U.S. Corporate Income Tax," prepared for Business Roundtable, September 2017.

budget baseline that acknowledges that longstanding tax provisions extended repeatedly on a short-term basis are in reality a permanent feature of current law.

We understand that tax reform will require a careful and balanced examination of existing tax preferences and that reform of the U.S. international tax system will be accompanied by appropriate safeguards to protect America's tax base. However, policymakers must be careful that proposals intended to protect against loss of the U.S. tax base are not so broad that they undermine the ability of American companies to compete against companies not encumbered by such restrictions.

At the end of the day, if U.S. tax reform is to be successful—if the United States is to end the competitive tax disadvantage that U.S. companies currently face—the reformed system should result in companies wanting to be headquartered in the United States over foreign domiciles. For too long we have observed investment dollars flowing out of the United States, companies inverting or being acquired by a foreign competitor, or entrepreneurs founding their new businesses outside of the United States due to the U.S. tax disadvantage. It is now time to establish a U.S. tax advantage. Let us once again make the United States the best place in the world to establish and grow a business.

* * * *

Business Roundtable, as the leaders of America's largest businesses, urges Congress and the Administration to work together with the highest priority to enact permanent, pro-growth tax reform this year in a fair and fiscally responsible manner. We stand ready to work with you to achieve this goal and to put America on a path of accelerated economic growth with higher wages and greater employment opportunities for all Americans.

CENTER FOR FISCAL EQUITY

Statement of Michael G. Bindner

Chairman Hatch and Ranking Member Wyden, thank you for the opportunity to submit these comments for the record to the Committee on Finance. As usual, we will preface our comments with our comprehensive four-part approach, which will provide context for our comments.

- A Value-Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure every American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25%.
- Employee contributions to Old-Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

Probably the most broken part of our tax code is how businesses are taxed. Corporations pay separate taxes while sole proprietors and "pass-throughs" pay taxes through the personal income taxes of their owners. This has some people being taxed twice, regardless of whether this is appropriate to extract taxes on higher incomes not collected through the business, while others face complexity on their personal forms, as well as a different set of rules. In 2003, President Bush and the Congress tried to fix this but could not, settling instead on a lower rate for dividends and capital gains.

The results of simply cutting rates were not pretty. CEOs and investors had an incentive to keep labor costs in check and pocket all productivity gains, which were huge through automation and outsourcing. Higher tax rates would have put a damper on such behavior. Of course, because not every rich person can be a CEO and because most companies borrowed money rather than issued stock, there were few good investments, which had beneficiaries of the 2001 and 2003 tax cuts seek more exotic vehicles, like oil futures and mortgage-backed securities. This (not any action by the GSEs) led to the mortgage boom and the Great Recession (as well as provisions in the 1986 tax reform that let homeowners use their houses as ATMs, a provision Trump wants to keep).

The President proposes simply lowering the tax on “pass-through” income, which will increase the number of companies fronting what would have been pay to individuals for salary and rent in order to take advantage of the lower rates. This is tax DEFORM not reform. We tried such cuts in 2003 and the proposed cut will yield the same result, especially if the President succeeds in defanging Dodd-Frank through regulatory reform (again deform).

There is a better way. Value-Added Taxes and Net Business Receipts Taxes (Subtraction VAT) will both simplify taxation and treat all businesses in the same way. While some special tax breaks might be preserved in the NBRT, most would not because there would be no way to justify taxing the labor or an activity and not the associated profit or taxing research salaries one way and production wages another. All profit and wage would be taxed at the same rate, which also removes the tax bias against wage income.

The proposed Destination-Based Cash Flow Tax is a compromise between those who hate the idea of a value-added tax and those who seek a better deal for workers in trade. It is not a very good idea because it does not meet World Trade Organization standards, though a VAT would. It would be simpler to adopt a VAT on the international level and it would allow an expansion of family support through an expanded child tax credit. Many in the majority party oppose a VAT for just that reason, yet call themselves pro life, which is true hypocrisy. Indeed, a VAT with enhanced family support is the best solution anyone has found to grow the economy and increase jobs.

Some oppose VATs because they see it as a money machine, however this depends on whether they are visible or not. A receipt visible VAT is as susceptible to public pressure to reduce spending as the FairTax is designed to be, however unlike the FairTax, it is harder to game. Avoiding lawful taxes by gaming the system should not be considered a conservative principle, unless conservatism is in defense of entrenched corporate interests who have the money to game the tax code.

Our VAT rate estimates are designed to fully fund non-entitlement domestic spending not otherwise offset with dedicated revenues. This makes the burden of funding government very explicit to all taxpayers. Nothing else will reduce the demand for such spending, save perceived demands from bondholders to do so—a demand that does not seem evident given their continued purchase of U.S. Treasury Notes.

Value-Added Taxes can be seen as regressive because wealthier people consume less, however when used in concert with a high-income personal income tax and with some form of tax benefit to families, as we suggest as part of the NBRT, this is not the case.

This is not to say that there will be no deductions. The NBRT will be the vehicle for social spending through the tax code.

The NBRT base is similar to a Value-Added Tax (VAT), but not identical. Unlike a VAT, an NBRT would not be visible on receipts and should not be zero rated at the border—nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal—covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

In the long term, the explosion of the debt comes from the aging of society and the funding of their health-care costs. Some thought should be given to ways to reverse a demographic imbalance that produces too few children while life expectancy of the elderly increases.

Unassisted labor markets work against population growth. Given a choice between hiring parents with children and recent college graduates, the smart decision will always be to hire the new graduates, as they will demand less money—especially in the technology area where recent training is often valued over experience.

Separating out pay for families allows society to reverse that trend, with a significant driver to that separation being a more generous tax credit for children. Such a credit could be "paid for" by ending the Mortgage Interest Deduction (MID) without hurting the housing sector, as housing is the biggest area of cost growth when children are added. While lobbyists for lenders and realtors would prefer gridlock on reducing the MID, if forced to choose between transferring this deduction to families and using it for deficit reduction (as both Bowles-Simpson and Rivlin-Domenici suggest), we suspect that they would choose the former over the latter if forced to make a choice. The religious community could also see such a development as a "pro-life" vote, especially among religious liberals.

Enactment of such a credit meets both our nation's short term needs for consumer liquidity and our long term need for population growth. Adding this issue to the pro-life agenda, at least in some quarters, makes this proposal a win for everyone.

Our proposals dovetail on our prior comments testimony on Individual Taxes. Tax benefits and filings that were once found in the individual code would be moved to the Business code. The most obvious provision is that most families will no longer have to file individual income taxes. Most will receive all of their tax benefits through an employer paid net business receipts tax, which is essentially a subtraction VAT. Health benefits through the Affordable Care Act or the health insurance exclusion for corporate income taxes will come through the NBRT, as will a refundable child tax credit paid through wages or education or social insurance benefits, rather than through end of the year tax filing, the EITC, TANF or SNAP.

The NBRT should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

The NBRT could also be used to shift governmental spending from public agencies to private providers without any involvement by the government—especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. This is a feature that is impossible with the FairTax or a VAT alone.

To extract cost savings under the NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit, provided that services are at least as generous as the current programs. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed. Increasing Part B and Part D premiums also makes it more likely that an employer-based system will be supported by retirees.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

Business owners, whether sole proprietors, partners, Schedule C or 1099 employees will file through the NBRT and also collect VAT, both of which will be coordinated with state revenue agencies and forwarded to the government. Form 1099 employees will not be required to file or get their own insurance unless they have multiple clients. Even then, the clients will pay the tax on their value added and provide insurance and retirement savings as if they were employees. We have inflated the number of "small businesses" for quite too long.

While some employee sole proprietors might like the freedom of multiple clients, most work for only one and would rather have full benefits and no tax filing. Congress can do this small thing for them in tax reform. Indeed, there is no reason to do tax reform without such changes (especially the child tax credit expansion). The larger firms will navigate and exploit the tax code regardless of reform, so their interests are not so important unless campaign contributions are really bribes.

The VAT and NBRT would eliminate the need for any corporate income tax, or as they used to be called, corporate profits taxes. Because consumption taxes burden labor and profit at the same rate, discounted tax rates on dividends and capital gains would no longer be required. Any residual income or inheritance surtax would be a way to maintain progressivity by charging a higher rate or rates for households receiving higher incomes from the same business activities.

Value-added taxes act as instant economic growth, as they are spur to domestic industry and its workers, who will have more money to spend. The Net Business Receipts Tax as we propose it includes a child tax credit to be paid with income of between $500 and $1,000 per month. Such money will undoubtedly be spent by the families who receive it on everything from food to housing to consumer electronics.

The tax reforms detailed here will make the nation truly competitive internationally while creating economic growth domestically, not by making job creators richer but families better off. The Center's reform plan will give you job creation. The current blueprint and the President's proposed tax cuts for the wealthy will not.

In September 2011, the Center submitted comments on Economic Models Available to the Joint Committee on Taxation for Analyzing Tax Reform Proposals. Our findings, which were presented to the JCT and the Congressional Budget Office (as well as the Wharton School and the Tax Policy Center), showed that when taxes are cut, especially on the wealthy, only deficit spending will lead to economic growth as we borrow the money we should have taxed. When taxes on the wealthy are increased, spending is also usually cut and growth still results. The study is available at *http://fiscalequity.blogspot.com/ 2011/09/economic-models-available-to-joint.html.*

Our current expansion and the expansion under the Clinton Administration show that higher tax rates always spur growth, while tax cuts on capital gains lead to toxic investments—almost always in housing. Business expansion and job creation will occur with economic growth, not because of investment from the outside but from the recycling of profits and debt driven by customers rather than the price of funds. We won't be fooled again by the saccharin song of the supply siders, whose tax cuts have led to debt and economic growth more attributable to the theories of Keynes than Stockman and Gramm.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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 19, 2017 hearing on "Business 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

[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*.

CVS HEALTH
1275 Pennsylvania Avenue, NW, Suite 700
Washington, DC 20004

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, thank you for the opportunity for CVS Health, on behalf of its subsidiaries and affiliated entities, to highlight the importance of comprehensive tax reform. CVS Health believes that tax reform that includes a significant and meaningful reduction in the corporate tax rate is the single most effective step Congress can take to strengthen the economy, create jobs, and foster innovation. CVS Health is committed to working with Congress and the Administration to advance tax reform that achieves these goals.

CVS Health is a U.S.-based domestic company with nearly 250,000 employees across the United States. As a pharmacy innovation company, we are committed to helping people on their path to better health. We operate 9,600 retail pharmacies and 1,100 Minute Clinics, and cover 90 million lives through our pharmacy benefit management division, in addition to our home infusion, long-term care, specialty and mail-order business operations throughout the country. CVS Health helps people, businesses and communities manage health care in more affordable, effective ways. One in three Americans have touch points with CVS Health services each year, and 75 percent of people in the United States live within 3 to 5 miles of a CVS store. Our unique integrated model increases access to quality care, delivers better health outcomes, and lowers overall health-care costs.

The single most important issue in tax reform for CVS Health is a significant and meaningful reduction in the corporate tax rate. With an effective federal tax rate of 35 percent, CVS Health pays one of the highest effective tax rates in the world on our operating income. In 2016, CVS Health's effective federal tax rate was actually *greater* than the statutory federal tax rate of 35 percent, and CVS Health paid nearly 1 percent of *all* corporate taxes collected in the United States. CVS Health strongly supports comprehensive tax reform that includes a meaningful reduction in the corporate rate, and believes that all corporate credits, preference items, and special deductions should be closely evaluated and scrutinized in pursuit of achieving a lower rate.

With a lower rate, CVS Health could immediately create new jobs and help grow the economy. For each single-digit reduction in the corporate rate, CVS Health could generate more than $90 million in incremental annual capital to be invested in communities across the United States. If the corporate rate was reduced to 25 percent, for example, that would free up $900 million a year that could be used to substantially increase our annual investments in growth and innovation. With a 25 percent corporate rate, CVS Health could build 50 new pharmacies and open 100 new Minute Clinics each year, *in addition* to our current planned investment and growth. We would also need to accelerate by 2 or 3 years the construction of a new distribution center to support our additional locations. We would further invest $140 to $200 million in new technology to improve health-care outcomes and access, including breakthrough digital tools to address issues like medication adherence.

By increasing our annual investment into new pharmacies, clinics, supporting facilities, and technologies, CVS Health could create as many as 3,000 permanent jobs within just 2 to 3 years, as well as up to 4,500 temporary construction jobs per year. In turn, this would generate more than $42 million in new annual salaries and benefits every year, significantly increasing employee purchasing power and spurring growth in local economies.

We support the proposal on corporate integration as a way to reduce the total tax burden on corporate earnings, and we appreciate your leadership and work on this issue. Like a reduction in the corporate rate, we believe that corporate integration would promote economic growth and competitiveness. Further, corporate integration tends to encourage equity financing, which reduces the preference for debt financing without the challenges of limiting the deductibility of interest expense.

In conclusion, CVS Health strongly supports comprehensive tax reform that meaningfully lowers the corporate rate. Tax reform is critical to faster economic growth, and we believe that Congress currently has a once in a lifetime opportunity to overhaul the tax code and drive economic growth. CVS Health strongly supports comprehensive tax reform that meaningfully lowers the corporate tax rate, and provides certainty and predictability for businesses to invest. CVS Health is committed to working with the Committee to advance this important goal.

DWIGHT J. DAVIS
King Springs Pecans, LLC
Managing Partner

Chairman Hatch, Ranking Member Wyden, Senator Isakson, and members of the Committee:

Thank you for the opportunity to address this esteemed Committee on the subject of tax reform and business interest deductibility. As background, I am the proud co-owner of King Springs Pecans in Hawkinsville, Georgia. I am also a strong supporter of the effort to reform our tax system.

Like many pecan farmers in Georgia, my business partner and I have made a sizeable investment into the production of food for both domestic and international markets. Also, like most farmers, our expenses in growing these crops do not occur at or near the time our revenues occur. Accordingly, we must borrow a sizeable amount of money to operate a successful family farm. Pecan farmers, like most farmers, have little or no interest income against which to claim a deduction for the interest expense associated with the revolving debt. The denial of the interest deduction will seriously erode the income from farms which, as is well known, already operate on slim margins. Moreover, the proposal to allow immediate expensing for one-time asset purchases will not offset the loss of the tax deduction for recurring interest expense.

The importance of access to debt is even more important during difficult financial times. As you know, Hurricane Irma ravaged the southeast and caused severe damage to the agricultural sector. The Georgia Pecan industry was especially hit hard. It is estimated that collectively we lost 30% of our yield this year and many pecan farmers lost 80% of their crops. Literally thousands of producing pecan trees were destroyed and this will adversely affect crop yields for years to come. Similar losses have occurred in the peach and blueberry crops.

As for our farm, we look to rebuild and replant any damaged trees. We will need access to capital for our operations and rebuilding. The deduction for interest payments will be critical to this recovery.

Thank you for this opportunity to be heard. If I can supply any additional information, please do not hesitate to contact me.

ENTERPRISE COMMUNITY PARTNERS
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Enterprise Community Partners thanks Chairman Orrin Hatch and the Committee for the opportunity to provide feedback on the Senate Finance Committee's hearing on business tax reform, held Tuesday, September 19, 2017. Enterprise is a national nonprofit organization whose mission is to create opportunity for low- and moderate-income people through affordable housing in diverse, thriving communities. We work to achieve this by introducing solutions through cross-sector public-private partnerships with financial institutions, governments, community organizations and other partners that share our vision. Since 1982, Enterprise has raised and invested $28.9 billion to help finance nearly 380,000 affordable homes across the United States. Two of the primary tools Enterprise uses to invest in communities are the Low-Income Housing Tax Credit (Housing Credit) and the New Markets Tax Credit (NMTC), both of which will be impacted by business tax reform. Enterprise has invested $12 billion in Housing Credit equity, financing nearly 150,000 affordable housing homes, and placed more than $700 million of NMTC equity in over 60 commercial and mixed-use developments nationwide.

We are especially grateful for Finance Committee Chairman Hatch's and Committee member Senator Maria Cantwell's leadership in championing legislation to expand and strengthen the Housing Credit, our nation's primary tool for encouraging private investment in affordable rental housing. As hearing witness Jeffrey D. DeBoer, President and CEO at the Real Estate Roundtable, stated in his written testimony, low-income housing is an example of a tax incentive that is "needed to address market failures and encourage capital to flow to socially desirable projects." We strongly urge the Committee to advance the Affordable Housing Credit Improvement Act of 2017 (S. 548) this year, and protect both the Credit and multifamily Housing

Bonds—a central component of the Housing Credit program—as part of any tax reform effort considered by Congress.

We also thank Senator Cantwell for raising the impact of tax reform on the Housing Credit during the Committee's hearing. As Senator Cantwell noted, the prospect of lower corporate tax rates has resulted in lower levels of investment capital in affordable housing development, impacting production at a time when our nation's shortage of affordable housing has never been greater. We urge the Senate Finance Committee to make any adjustments to the Housing Credit needed beyond those proposed in the Affordable Housing Credit Improvement Act to ensure that affordable housing production continues at a robust level regardless of other changes made in tax reform.

Enterprise also urges the Senate Finance Committee to preserve and expand the NMTC as part of any tax reform effort considered by Congress. As Chairman Hatch noted in his opening statement, a chief goal of tax reform should be economic growth, and the NMTC is a proven and effective tool to spur economic development and revitalize distressed urban and rural communities. Without the NMTC, low-income communities across the country will continue to be starved of the patient capital needed to support and grow businesses, create jobs and increase economic opportunity. Enterprise urges the committee to support the New Markets Tax Credit Extension Act of 2017 (S. 384), introduced by Senators Roy Blunt (R–MO) and Ben Cardin (D–MD), to indefinitely extend the NMTC. This legislation has bipartisan support, including the support of several members of the Finance Committee.

THE HOUSING CREDIT

The Housing Credit has a Remarkable Track Record

President Reagan and the Congress showed remarkable foresight when they created the Housing Credit as part of the Tax Reform Act of 1986. The Housing Credit is now our nation's most successful tool for encouraging private investment in the production and preservation of affordable rental housing, with a proven track record of creating jobs and stimulating local economies. For over 30 years, the Housing Credit has been a model public-private partnership program, bringing to bear private-sector resources, market forces, and state-level administration to finance more than 3 million affordable apartments—nearly one-third of the entire U.S. inventory—giving more than 7 million households, including low-income families, seniors, veterans, and people with disabilities, access to homes they can afford. Roughly 40 percent of these homes were financed in conjunction with multifamily Housing Bonds, which are an essential component of the program's success.

The Housing Credit is a Proven Solution to Meet a Vast and Growing Need

Despite the Housing Credit's tremendous impact, there are still over 11 million renter households—roughly one out of every four—who spend more than half of their income on rent, leaving too little for other necessary expenses like transportation, food, and medical bills. This crisis is continuing to grow. HUD reports that as of 2015, the number of households with "worst case housing needs" had increased by 38.7 percent over 2007 levels, when the recession began, and by 63.4 percent since 2001. A study by Harvard University's Joint Center for Housing Studies and Enterprise Community Partners estimates that the number of renter households who pay more than half of their income towards rent could grow to nearly 15 million by 2025.

Without the Housing Credit, there would be virtually no private investment in affordable housing. It simply costs too much to build rental housing to rent it at a level that low-income households can afford. In order to develop new apartments that are affordable to renters earning the full-time minimum wage, construction costs would have to be 72 percent lower than the current average.

The Housing Credit Creates Jobs

Housing Credit development supports jobs—roughly 1,130 for every 1,000 Housing Credit apartments developed, according to the National Association of Home Builders (NAHB). This amounts to roughly 96,000 jobs per year, and more than 3.4 million since the program was created in 1986. NAHB estimates that about half of the jobs created from new housing development are in construction. Additional job creation occurs across a diverse range of industries, including the manufacturing of lighting and heating equipment, lumber, concrete, and other products, as well as jobs in transportation, engineering, law, and real estate.

The Housing Credit Stimulates Local Economies and Improves Communities

The Housing Credit has a profound and positive impact on local economies. NAHB estimates that the Housing Credit adds $9.1 billion in income to the economy and generates approximately $3.5 billion in federal, state, and local taxes each year.

Conversely, a lack of affordable housing negatively impacts economies. Research shows that high rent burdens have priced out many workers from the most productive cities, resulting in 13.5 percent foregone GDP growth, a loss of roughly $1.95 trillion, between 1964 and 2009.

Housing Credit development also positively impacts neighborhoods in need of renewal. About one-third of Housing Credit properties help revitalize distressed communities. Stanford University research shows Housing Credit investments improve property values and reduce poverty, crime, and racial and economic isolation, generating a variety of socio-economic opportunities for Housing Credit tenants and neighborhood residents.

Affordable Housing Improves Low-Income Households' Financial Stability

Affordable housing promotes financial stability and economic mobility. It leads to better health outcomes, improves children's school performance, and helps low-income individuals gain employment and keep their jobs. Affordable housing located near transportation and areas with employment opportunities provides low-income households with better access to work, which increases their financial stability and provides employers in those areas with needed labor.

Families living in affordable homes have more discretionary income than low-income families who are unable to access affordable housing. This allows them to allocate more money to other needs, such as health care and food, and gives them the ability to pay down debt, access childcare, and save for education, a home down payment, retirement, or unexpected needs.

The Housing Credit is a Model Public-Private Partnership

The Housing Credit is structured so that private sector investors provide upfront equity capital in exchange for a credit against their tax liability over 10 years, which only vests once the property is constructed and occupied by eligible households paying restricted rents. This unique, market-based design transfers the risk from the taxpayer to the private sector investor. In the rare event that a property falls out of compliance during the first 15 years after it is placed in service, the Internal Revenue Service can recapture tax credits from the investor. Therefore, it is in the interest of the private sector investors to ensure that properties adhere to all program rules, including affordability restrictions and high-quality standards—adding a unique accountability structure to the program.

The Housing Credit is State-Administered With Limited Federal Bureaucracy

The Housing Credit requires only limited federal bureaucracy because Congress wisely delegated its administration and decision-making authority to state government as part of its design. State Housing Finance Agencies, which administer the Housing Credit in nearly every state, have statewide perspective; a deep understanding of the needs of their local markets; and sophisticated finance, underwriting, and compliance capacity. States develop a system of incentives as part of their Qualified Allocation Plans (QAP), which drives housing development decisions, including property siting, the populations served and the services offered to residents. States are also deeply involved in monitoring Housing Credit properties, including compliance audits and reviews of financial records, rent rolls, and physical conditions.

The Housing Credit is Critical to Preserving Our Nation's Existing Housing Investments

The Housing Credit is our primary tool to preserve and redevelop our nation's current supply of affordable housing. For every new affordable apartment created, two are lost due to deterioration, abandonment, or conversion to more expensive housing. Without the Housing Credit, our ability to revitalize and rehabilitate our nation's public housing and Section 8 housing inventory, decades in the making, would be significantly diminished. In addition to putting the residents of these properties at risk of displacement, we would lose these investments that taxpayers have already made. Preservation is also more cost-effective, costing 33 percent less than new construction.

The Housing Credit is the Single Largest Financing Source for Affordable Rural Homes

Since it was created, the Housing Credit has developed or preserved 270,000 affordable homes in rural communities, supporting 1.15 million jobs and generating $86.9 billion in local income. In rural areas, where direct funding for rural housing programs has been cut significantly, the Housing Credit is the backbone for preservation and capital improvements to the existing housing stock, comprising nearly half of all financing. Low-income rural residents ' incomes average just $12,960, and they are often living in areas with extremely limited housing options, making preservation of the existing housing stock crucial.

The Demand for Housing Credits Exceeds the Supply

Viable and sorely needed Housing Credit developments are turned down each year because the cap on Housing Credit authority is far too low to support the demand. In 2014—the most recent year for which data is available—state Housing Credit allocating agencies received applications requesting more than twice their available Housing Credit authority. Many more potential applications for worthy developments are not submitted in light of the intense competition, constrained only by the lack of resources. A recent analysis by accounting firm CohnReznick finds that there is a 97.8% occupancy rate for Housing Credit properties, underscoring the successful operation of Housing Credit properties and the need for more resources to meet the nation's growing demand for affordable housing.

The scarcity of Housing Credit resources forces state allocating agencies to make difficult trade-offs between directing their extremely limited Housing Credit resources to preservation or new construction, to rural or urban areas, to neighborhood revitalization or developments in high opportunity areas, or to housing for the homeless, the elderly, or veterans. There simply is not enough Housing Credit authority to fund all of the properties needed, but with a substantial increase in resources, many more of these priorities would be addressed—and the benefits for communities would be even greater.

Though the need for Housing Credit-financed housing has long vastly exceeded its supply, Congress has not increased Housing Credit authority permanently in 17 years.

We Urge Congress to Expand and Strengthen the Housing Credit

To meaningfully grow our economy and address our nation's growing affordable housing needs through tax reform, we urge Congress to increase the cap on Housing Credit authority by 50 percent. Such an expansion would support the preservation and construction of up to 400,000 additional affordable apartments over a 10-year period.

S. 548, which would authorize such an expansion, has earned strong bipartisan support in the Senate and among Senate Finance Committee members. This legislation would increase Housing Credit allocation authority by 50 percent phased in over 5 years, and enact roughly two dozen changes to strengthen the program by streamlining program rules, improving flexibility, and enabling the program to serve a wider array of local needs. For example, S. 548 would encourage Housing Credit development in rural and Native communities, where it is currently more difficult to make affordable housing developments financially feasible; Housing Credit developments that serve the lowest-income tenants, including veterans and the chronically homeless; the development of mixed-income properties; the preservation of existing affordable housing; and development in high-opportunity areas. The legislation would also generate a host of benefits for local communities, including raising local tax revenue and creating jobs.

We also call on Congress to retain the tax exemption on multifamily Housing Bonds, which are essential to Housing Credit production. In addition, we encourage Congress to make any adjustments needed in order to offset the impact of a lower corporate tax rate on Housing Credit investment and subsequent affordable housing production, a concern that Senator Cantwell voiced during the hearing.

An investment in the Housing Credit is an investment in individuals, local communities, and the economy. It transforms the lives of millions of Americans, many of whom are able to afford their homes for the first time—and it transforms their communities and local economies. Enterprise applauds the leadership the Senate Finance Committee has shown in support of the Housing Credit to date and urges the Committee to expand and strengthen the Housing Credit and multifamily Housing Bonds in tax reform.

NEW MARKETS TAX CREDIT

The NMTC is a Successful Component of the Business Tax System and Should Be Preserved

The NMTC encourages private capital to flow to some of the most economically distressed communities in the country, both urban and rural, by providing a modest tax incentive to investors who provide capital to qualified Community Development Entities (CDEs). The NMTC enjoys bipartisan support because it is an effective, targeted and cost-efficient financing tool valued by businesses, communities and investors. At the end of 2016, the NMTC had financed over 5,400 businesses, creating 178 million square feet of manufacturing, office and retail space in distressed communities that would not have been possible without the Credit. In 2010 alone, NMTC investments in operational activities generated almost $1.1 billion in federal tax revenue, easily offsetting the estimated $720 million cost of the program for the federal government.

As the Committee considers reforms to the nation's tax code that incentivize economic growth and job creation, our nation's most distressed communities should remain at the forefront of the conversation. The NMTC has proven to be a successful component of the current business tax system that should be preserved as the tax code is modernized.

The NMTC Incentivizes Investments That Would Not Have Been Made Without the Credit

In 2007, the U.S. Government Accountability Office surveyed investors and reported that 88 percent indicated they would not have made the investment without the NMTC, and almost two-thirds said they increased their investments in low-income communities because of the NMTC. The NMTC makes it possible to invest in low-income communities with better rates and terms, and more flexible features, than would be available in the market. Without the NMTC, urban and rural communities across the country would continue to suffer from disinvestment and continue to be starved of the capital needed to spur economic growth.

The NMTC Attracts Capital to Some of the Nation's Most Distressed Communities

Many of the nation's low-income communities, both urban and rural, struggle to access the capital necessary to support a business, create jobs or sustain a healthy economy. These communities have such a dearth of resources—including vacant properties, neglected infrastructure and limited education opportunities—that investments are not feasible without a tax incentive. The NMTC encourages private investment in these communities by providing a modest tax incentive that attracts the patient capital that is necessary to revitalize these severely distressed communities.

By law, NMTC investments must be made in census tracts where the individual poverty rate is at least 20 percent or where median family income does not exceed 80 percent of the area median, but the majority of NMTC investments are made in communities exhibiting even more severe economic distress. These low-income urban and rural communities face diminishing jobs, high-unemployment, and bleak opportunities for economic advancement. The NMTC provides these communities with the access to patient capital that is needed to support and grow businesses, create jobs, and sustain healthy local economies.

The NMTC Leverages $8 of Private Capital for Every $1 in NMTC Investment

Between 2003 and 2015, NMTC investments directly created over 750,000 jobs and leveraged over $80 billion in capital investment in credit-starved businesses in communities with high poverty and unemployment rates. According to the Treasury Department, every $1 in investment from the NMTC program leverages approximately $8 of private capital. A recent analysis of Treasury Department data indicates that NMTC-financed businesses and jobs generate more income tax revenue than the NMTC actually costs. Additionally, the NMTC creates jobs at a cost to the federal government of less than $20,000 per job.

The NMTC Jumpstarts Rural Manufacturing

The NMTC has had a profoundly positive impact in rural communities across the country. The most popular use of the NMTC in rural America is to support the manufacturing sector. NMTC financing typically goes to business expansions, new equipment and facilities, and working capital. Between 2003 and 2014, the NMTC financed 223 rural manufacturing projects totaling $4.8 billion.

The NMTC Should Be a Permanent Part of the Tax Code

The NMTC was authorized in the Community Renewal Tax Relief Act of 2000 with bipartisan support and has been reauthorized numerous times since its initial temporary authorization, most recently in the 2015 PATH Act, which extended the NMTC through 2019. As a proven public-private partnership that leverages private investment to grow local economies, create jobs and transform neighborhoods, the NMTC should be a permanent part of the tax code. In addition to allowing the program to lift up more distressed communities, permanence would provide stability and certainty to this critical community development tool for low-income communities. NMTC equity pricing would subsequently increase, providing for greater program efficiency and increased leveraging of private capital.

Senators Roy Blunt (R–MO) and Ben Cardin (D–MD) introduced the New Markets Tax Credit Extension Act of 2017 (S. 384) to provide an indefinite extension to the NMTC, increase the annual NMTC allocation and index the allocation to inflation and provides Alternative Minimum Tax (AMT) relief for NMTC investments. Enterprise urges Congress to enact this legislation through tax reform.

We thank you for this opportunity to share comments on tax reform. If you have any questions regarding these comments, please do not hesitate to reach out to me at mmcfadden@enterprisecommunity.org, or Emily Cadik, Director of Public Policy, at ecadik@enterprisecommunity.org.

Sincerely,

Marion McFadden
Vice President, Public Policy
Enterprise Community Partners

LIKE-KIND EXCHANGE STAKEHOLDER COALITION

September 27, 2017

The Honorable Orrin Hatch
Chairman
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

Dear Chairman Hatch and Ranking Member Wyden:

We are submitting the following statement for the record in response to the Senate Committee on Finance's hearing on September 19, 2017 entitled "Business Tax Reform." As you consider ways to create jobs, grow the economy, and raise wages through tax reform, we strongly urge that current law be retained regarding like-kind exchanges under section 1031 of the Internal Revenue Code ("Code"). We further encourage retention of the current unlimited amount of gain deferral.

Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses, which in turn strengthen the U.S. economy and create jobs. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Specifically, section 1031 provides that taxpayers do not immediately recognize a gain or loss when they exchange assets for "like-kind" property that will be used in their trade or business. They do immediately recognize gain, however, to the extent that cash or other "boot" is received. Importantly, like-kind exchanges are similar to other non-recognition and tax deferral provisions in the Code because they result in no change to the economic position of the taxpayer.

Since 1921, like-kind exchanges have encouraged capital investment in the U.S. by allowing funds to be reinvested back into the enterprise, which is the very reason section 1031 was enacted in the first place. This continuity of investment not only benefits the companies making the like-kind exchanges, but also suppliers, manufacturers, and others facilitating them. Like kind exchanges ensure both the best use of real estate and a new and used personal property market that significantly benefits start-ups and small businesses. Eliminating like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity.

A 2015 macroeconomic analysis by Ernst and Young found that either repeal or limitation of like kind exchanges could lead to a decline in U.S. GDP of up to $13.1 billion annually.[1] The Ernst and Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, manufacturers, etc. A 2016 report by the Tax Foundation estimated even greater economic contraction—a loss of 0.10% of GDP, equivalent to $18 billion annually.[2]

Companies in a wide range of industries, business structures, and sizes rely on the like-kind exchange provision of the Code. These businesses—which include real estate, construction, agricultural, transportation, farm/heavy equipment/vehicle rental, leasing and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

A microeconomic study by researchers at the University of Florida and Syracuse University, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.[3] The immediate recognition of a gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A $1 million limitation of gain deferral per year, as proposed by the Obama Administration,[4] would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle/equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes, multifamily properties or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property/casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and provides inventories of affordable used assets for small businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity.

In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100-year existence in the Code. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as economic growth, job creation and increased competitiveness.

Thank you for your consideration of this important matter.

Sincerely,

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[1] "Economic Impact of Repealing Like-Kind Exchange Rules," Ernst and Young (March 2015, Revised November 2015), at (iii), available at: *http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.*

[2] "Options for Reforming America's Tax Code," Tax Foundation (June, 2016) at p. 79, available at: *http://taxfoundation.org/article/options-reforming-americas-tax-code.*

[3] David Ling and Milena Petrova, "The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate" (March 2015, revised June 2015), at 5, available at: *http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.*

[4] "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," at 107, available at: *https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.*

Air Conditioning Contractors of America
American Car Rental Association
American Farm Bureau Federation
American Rental Association
American Seniors Housing Association
American Truck Dealers
American Trucking Associations
Associated Equipment Distributors
Associated General Contractors of America
Avis Budget Group, Inc.
Building Owners and Managers Association (BOMA) International
C.R. England, Inc.
Equipment Leasing and Finance Association
Federation of Exchange Accommodators
International Council of Shopping Centers
Investment Program Association
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of Realtors
National Automobile Dealers Association
National Business Aviation Association
National Multifamily Housing Council
National Ready Mixed Concrete Association
National Stone, Sand, and Gravel Association
Truck Renting and Leasing Association

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Introduction

The nearly 1.3 million members of the National Association of Realtors (NAR) thank the U.S. Senate Committee on Finance for holding this hearing on "Business Tax Reform."

NAR is America's largest trade association, including our eight affiliated Institutes, Societies, and Councils, five of which focus on commercial transactions. Realtors are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of Realtors.

Tax Reform

NAR acknowledges the complexity of the current tax system and seeks tax reforms that support the goals of homeownership and freedom to buy, maintain and sell real estate. At the same time, the current real estate tax provisions are among the most widely used and most readily understood tax provisions. Millions of real estate investment decisions have been made with the current tax law factored in. Adversely changing the rules on existing investments could harm economic recovery and future job creation and would be unfair to those who relied on those rules.

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. Commercial real estate adds value to the places that we work, conduct commerce, live, and play.

I. Section 1031 Like-Kind Exchanges

Since 1921, U.S. tax law has recognized that the exchange of one investment or business-use property for another of like-kind results in no change in the economic position of the taxpayer, and therefore, should not result in the immediate imposition of income tax. The like-kind exchange rules permit the deferral of taxes, so long as the taxpayer satisfies numerous requirements and consummates both a sale and purchase of replacement property within 180 days.

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. Moreover, 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.

A 2015 study [1] 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. A second study by EY concluded that new restrictions on Section 1031 would increase the cost of capital, discourage entrepreneurship and risk taking, and slow the rate of investment.[2]

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.

II. Business Interest Deduction

Another recent tax reform idea with the potential to cause very serious disruption to the commercial real estate sector is the proposal to eliminate the deduction for net investment expense included in the House Republican Blueprint. The ability to finance productive investment and entrepreneurial activity with borrowed capital has driven economic growth and job creation in the United States for generations. Since its inception, our tax system has appropriately allowed business interest expense to be deducted as an ordinary and necessary business expense.

Repealing or imposing limits on the deductibility of business interest would fundamentally change the underlying economics of business activity, including commercial real estate transactions. This could lead to fewer new projects being developed, fewer jobs being created, and fewer loans being refinanced. Legislation altering the tax treatment of existing debt could harm successful firms, pushing some close to the brink of insolvency or even into bankruptcy.

Tax reform must preserve the current tax treatment of business interest. By increasing the cost of capital, limitations on business interest deductibility could dramatically reduce real estate investment, reducing property values across the country, and discouraging entrepreneurship and responsible risk-taking.

III. Carried Interest

Many real estate partnerships utilize the common practice of providing additional incentives for a general partner to perform well by sharing some of the profits above a certain rate with them via a carried interest, even when they contributed little or no capital to the enterprise. The general partner's interest is "carried" with the property until it is sold, which can be a number of years after the enterprise is formed and limited partners have received profit distributions. That carried interest is then taxed at the capital gains rate, as a reward for entrepreneurs (general partners, in this case) who take the risks inherent in new projects.

The carried interest provision is an integral product of the flexibility Congress imbued in the tax rules for partnerships more than 50 years ago. The current tax treatment of carried interests is based on the established partnership tax principle that partners are taxed based on their share of partnership income (ordinary or capital gains), rather than based on the character of the partner (general or limited) to whom the income is allocated. The partnership structure has been a huge success, giving investors and entrepreneurs in many industries the tools to create and grow

[1] "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.
[2] "Economic Impact of Repealing Like-Kind Exchange Rules," EY, November 2015.

businesses, build shopping centers, found technology companies, and create millions of jobs.

Increasing the tax burden on these real estate partnerships, and particularly on those with operational expertise, by changing the treatment of a general partner's carried interest from capital gains to ordinary income would make real estate a less attractive investment. When the value of real estate investment is impaired, there is an indirect impact on all real estate. The character of real estate-related income, including carried interest, should continue to be determined at the partnership level and the new regime should continue to recognize that entrepreneurial risk-taking often involves more than just the contribution of capital.

IV. Depreciation

The current law depreciation rules are out of date and do not reflect the actual economic life of structures. The 27.5- and 39-year cost recovery periods should be shortened to a depreciable life for real estate that more accurately reflects the economic life of the property.

Independent studies indicate that the economic life of real property ranges between 18 and 30 years. Economic depreciation is more than just physical wear and tear, but also includes adjustments to the value of real property caused by changes in tastes, new technology, and by improvements in the quality of new assets relative to old assets (obsolescence).

NAR and several other real estate-related trade associations funded academic research on the actual rate of economic depreciation of commercial and investment real property. The study results,[3] released in early 2016, showed that the economic depreciation of real property is much shorter than the current tax rules provide, and is evidence that depreciable lives should *not* be extended in tax reform. Rather, we urge Congress to shorten the depreciable lives of structures to better reflect their true economic lives.

Conclusion

Thank you for the opportunity to submit these comments. NAR appreciates the Senate Committee on Finance for its open and collaborative process as it seeks to reform our Nation's tax code. In order to devise a fairer and simpler tax code, the input of stakeholders at all levels is imperative to avoid unintended consequences.

Commercial real estate adds value to the U.S. economy at every level, and a well-tuned tax policy can help it continue to innovate, create jobs and add wealth to every community in the U.S. NAR looks forward to continued collaboration with this Committee as it works to devise a fairer and simpler tax code that boosts the overall economy.

NATIONAL MINING ASSOCIATION (NMA)
101 Constitution Avenue, NW, Suite 500 East
Washington, DC 20001

Tax Policies Should Keep U.S. Mining Globally Competitive

The National Mining Association is pleased to offer its recommendations in connection with the Senate Finance Committee's hearing on Business Tax Reform. NMA strongly supports a substantial reduction in the corporate tax rate; the current federal rate of 35 percent coupled with state taxes are a detriment to our industry.

NMA believes that Congress should reject unwarranted proposals that would significantly harm the competitiveness of domestic miners by eliminating or reducing the present-law percentage depletion tax deduction for mining activities, by eliminating the net interest expense deduction, or by otherwise increasing taxes on miners. U.S. mineral and coal producers play an integral role in fostering continued American economic prosperity and energy security.

Background on U.S. Mining Industry

U.S. mineral and coal miners play an integral role in fostering continued American economic prosperity by meeting, through domestic production, much of the nation's growing energy needs and by producing important minerals for commercial use as

[3] "Tax Policy Implications of New Measures of Economic Depreciation of Commercial Structures," PwC, April 2016.

cost-effective inputs for farms, factories and other job creators. Mined products are used in every part of the economy.

Mining producers are vital to continued economic prosperity by providing 30% of the nation's electricity through affordable coal power and another 20% through uranium powered nuclear plants—totaling 50% of our nation's electricity supply. While coal-based electricity has increased by more than 170 percent over the past four decades, emissions have decreased by 90 percent. New high-efficiency coal plants can further reduce emissions by more than 30 percent.

Hardrock miners provides essential minerals for commercial use as cost-effective inputs for farmers, national defense systems, and high technology such as smart phones, hybrid cars and minerals for the manufacturing base. Domestic mining products are used in virtually every part of the economy. Ores and metals are used in the production of capital goods for manufacturing and construction. Essential electronic, telecommunications and medical processes depend on metals. Non-metallic minerals are used in agriculture as fertilizers, in medicine as pharmaceuticals and in construction and other industrial processes.

The United States needs the public policies that unlock, and do not hamper, the full potential of our immense mineral endowment in a highly competitive world economy in which the demand for minerals continues to grow.

The mining industry, comprised of both coal and hardrock minerals miners, has a combined direct and indirect employment of almost 1.7 million jobs in all 50 states—with one of the highest paying private sector average wages at: $74,695 per year.

U.S. mining's total direct and indirect economic contribution to GDP was over $220 billion in 2015—generating almost $44 billion in tax payments to federal, state, and local governments. The value added to GDP by major industries that consume processed mineral materials was $2.4 trillion in 2014. Mining exports made significant positive contributions to America's balance of trade.

Capital Costs

It is important to recognize the unique nature of mining investments. Mining requires significant financial commitments to long-term projects to deliver a competitive product at a low margin. Enormous amounts of capital must be expended at the front end of mining projects to realize future returns. For example, a number of mines in the Western states have capital costs around $500 million or more, and it is not unusual for a world-class mining project today to require $1 billion in engineering, development, construction and other costs to commence and sustain the enterprise.

Additionally, current laws result in a process that takes 5 to 10 years to navigate, putting the U.S. dead last among top mining countries when ranked on permitting delays.

Competitiveness

Many American mines have large reserves, but often of lower ore grades than other mines around the world. Many U.S. mines cannot bear large tax increases and still remain globally competitive. Other U.S. mines would have their productive lives significantly shortened by major tax increases. As the U.S. economy is recovering from the recession, the mining industry is hiring and is poised to expand production and increase hiring. The industry is a major job creator, but tax increases would jeopardize that hiring.

Tax Reform

It has been suggested that tax reform could involve the elimination of various so-called "tax expenditures." The Joint Committee on Taxation has identified tax expenditures specifically related to mining. These provisions are not "loopholes" but are instead essential components of domestic mineral and coal mining operations. Elimination of the priorities listed below could result in a net tax increase on the mining industry if the corporate tax rate is not lowered enough to offset these provisions.

Percentage Depletion. A key tax provision incentivizing mining in the U.S. is percentage depletion. Under longstanding law, taxpayers producing from mines, wells, and other natural deposits are allowed to claim as a deduction for depletion a percentage of the gross income from these mining properties. This deduction is known as "percentage depletion."

It should be noted that percentage depletion is applied to all extractive industries, including many independent oil and gas producers. Internal Revenue Code section 613 lists percentage depletion rates for more than 100 different products from mines wells and other natural deposits, including gold, silver, copper, iron ore, and other metal mines, sulphur, uranium, clay, bauxite, coal, lignite, rock asphalt, gravel, pumice, and sand.

The percentage depletion deduction is an essential component of domestic mineral and coal mining operations and must be retained. The percentage depletion tax deduction recognizes the unique nature of mining investments and recognizes that the next ore body or coal mine to be mined will be more costly since the reserve may be smaller and the geology more difficult. Mining requires significant financial commitments to long-term projects to deliver a competitive product at a low margin. Enormous amounts of capital must be expended at the front end of mining projects to realize future returns. With such sizable capital costs, cost recovery through percentage depletion has a significant effect on the margins and prices at which minerals can be profitably sold. The present-law percentage depletion deduction is vitally important to the competitiveness of the domestic mining industry and to the U.S. economy, it must be retained.

Interest Expense. The House tax reform blueprint proposes eliminating the net interest expense deduction on business indebtedness. Miners strongly believe that the interest deduction should be retained for both existing and new debt. Companies invest a tremendous amount of capital to start up new and replacement mines with some of the most modern equipment. In addition, maintaining existing mines also requires significant capital outlays due to the nature of mining. Consequently, the ability to obtain debt and restructure existing debt is a fundamental business need to the mining industry and too many domestic manufacturers beyond the mining sector. The loss of net interest expense deduction could devastate many mining companies.

Summary

Tax increases would jeopardize hiring in the mining industry and put the jobs, salaries and benefits of hundreds of thousands of miners at risk. Increased taxes on the miners through elimination of longstanding tax rules such as percentage depletion and the deduction for interest expense, would likely result in increased electricity prices and higher prices for consumers, sending crippling effects throughout the U.S. economy. Tax increases would not only affect the hundreds of thousands of people that the industry directly employs, but also negatively impact the additional secondary employment that is generated through demand for mining support services and generated by consuming industries through processing and refining activities and manufacturing operations.

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The National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) respectfully submit this statement for the record for the Senate Finance Committee's September 19, 2017, hearing titled "Business Tax Reform."

For more than 20 years, the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) have partnered in a joint legislative program to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of more than 160 state and local affiliates, NAA encompasses over 73,000 members representing nearly 9 million apartment homes globally.

Background on the Multifamily Housing Sector

Prior to addressing the multifamily housing industry's recommendations for tax reform, it is worthwhile to note the critical role multifamily housing plays in providing safe and decent shelter to millions of Americans, as well as the sector's considerable impact on our nation's economy.

Today, 111 million Americans, over one-third of all Americans, live in rental housing (whether in an apartment home or single-family home).[1] There are 18.7 million renter households, or nearly 16 percent of all households, who live in apartments (buildings with five or more units).[2] On an aggregate basis, the value of the entire apartment stock is $3.3 trillion.[3] Our industry and its 38.8 million residents contributed $1.3 trillion to the national economy in 2013 while supporting 12.3 million jobs.[4]

The U.S. is in the midst of a fundamental shift in our housing dynamics as changing demographics and housing preferences drive more people toward renting as their housing of choice. Today, demand for apartments is at unprecedented levels as the number of renters has reached an all-time high. Since 2010, the number of renter households has increased by an average of more than 800,000 annually—almost as much as 1.2 million a year, by some measures.[5] Meanwhile, apartment vacancy rates as measured by MPF Research fell or remained the same for 7 straight years from 2009 to 2016.[6]

Changing demographics are driving the demand for apartments. Married couples with children now represent only 19 percent of households. Single-person households (28 percent), single parent households (9 percent) and roommates (7 percent) collectively account for 43 percent of all households, and these households are more likely to rent.[7] Moreover, the surge toward rental housing cuts across generations. In fact, nearly 73 million Baby Boomers (those born between 1946 and 1964), as well as other empty nesters, have the option of downsizing as their children leave the house and many will choose the convenience of renting.[8] Over half (58.6 percent) of the net increase in renter households from 2006 to 2016 came from householders 45 years or older.[9]

Unfortunately, the supply of new apartments is falling well short of demand. Just-released research by Hoyt Advisory Services, Dinn Focused Marketing, Inc. and Whitegate Real Estate Advisors, LLC, *U.S. Apartment Demand—A Forward Look,* commissioned by NMHC/NAA shows that the nation will need 4.6 million new apartments by 2030, or an average of 328,000 units a year.[10] Just 244,000 apartments were delivered from 2012–2016.[11]

The bottom line is that the multifamily industry provides housing to tens of millions of Americans while generating significant economic activity in communities nationwide. Changing demographics and growing demand will only cause the industry's footprint to expand in the coming years. As will be described below, tax policy will have a critical role to play in ensuring the multifamily industry can efficiently meet the needs of America's renters.

Key Priorities for Tax Reform

Owners, operators, and developers of multifamily housing, who favor pro-growth tax reform that does not disadvantage multifamily housing relative to other asset classes, have a considerable stake in the outcome of the debate over how to reform and simplify the nation's tax code. Industry participants pay federal tax at each stage of an apartment's lifecycle. Federal taxes are paid when properties are built, operated, sold, or transferred to heirs.

[1] 2015 American Community Survey, 1-Year Estimates, U.S. Census Bureau, "Total Population in Occupied Housing Units by Tenure."
[2] 2015 American Community Survey, 1-Year Estimates, U.S. Census Bureau, "Tenure by Units in Structure."
[3] NMHC estimate based on a report by Rosen Consulting. Updated June 2014.
[4] National Multifamily Housing Council and National Apartment Association.
[5] NMHC tabulations of American Community Survey and Current Population Survey microdata.
[6] MPF Research.
[7] 2015 Current Population Survey, Annual Social and Economic Supplement, U.S. Census Bureau, "America's Families and Living Arrangements: 2015: Households" (H table series), table H3/Family groups (FG series), table FG6.
[8] Annual Estimates of the Resident Population by Single Year of Age and Sex for the United States: April 1, 2010 to July 1, 2015, U.S. Census Bureau. Baby Boomers are defined as those born 1946 through 1964.
[9] NMHC tabulations of 2016 Current Population Survey, Annual Social and Economic Supplement, U.S. Census Bureau.
[10] Hoyt Advisory Services, Dinn Focused Marketing, Inc., and Whitegate Real Estate Advisors, LLC, "U.S. Apartment Demand—A Forward Look," May 2017, p. 38.
[11] NMHC tabulations of 2016 Current Population Survey, Annual Social and Economic Supplement, U.S. Census Bureau.

In providing our recommendations, we are guided by the principle that real estate relies on the free-flow of capital and that investment decisions are driven by after-tax rates of return rather than by statutory tax rates standing alone. The number of layers of taxation, the marginal rate of tax imposed on income, cost recovery rules, investment incentives and taxes imposed when properties are sold, exchanged or transferred to heirs are all critical in assessing the viability of an investment. In developing reform proposals, we recommend that the Finance Committee and Congress consider—but also look well beyond—lowering statutory tax rates and focus on the ability of a reformed system to efficiently allocate capital and drive job-creating business investment. We also urge the Committee to be mindful about how tax reform could impact existing investment and to focus on the critical transition rules that will be necessary to avoid disturbing the value of current assets. As outlined in the pages below, NMHC/NAA believe that any tax reform proposal must:

- Protect pass-through entities from higher taxes or compliance burdens;
- Retain the full deductibility of business interest;
- Ensure depreciation rules avoid harming multifamily real estate;
- Preserve the ability to conduct like-kind exchanges;
- Maintain the current law tax treatment of carried interest;
- Preserve and strengthen the Low-Income Housing Tax Credit;
- Maintain the current law estate tax; and
- Repeal or reform the Foreign Investment in Real Property Tax Act to promote investment in the domestic apartment industry.

Priority 1: Tax Reform Must Not Harm Pass-Through Entities

The multifamily industry is dominated by "pass-through" entities (*e.g.,* LLCs, partnerships and S corporations) rather than publicly held corporations (*i.e.,* C corporations). Indeed, over three-quarters of apartment properties are owned by pass-through entities.[12] This means that a company's taxable income is passed through to the owners, who pay taxes on their share of the income on their individual tax returns. This treatment contrasts with the taxation of large publicly held corporations that generally face two levels of tax. Those entities remit tax at the corporate level under the corporate tax system. Shareholders are then taxed upon the receipt of dividend income.

In addition to pass-through entities, a significant number of industry participants are organized as REITs. So long as certain conditions are satisfied, REITs pay no tax at the entity level. Instead, REIT shareholders are taxed on distributed dividends.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities or REITs. For example, while many are calling for a reduction in the nation's 35 percent corporate tax rate, flow-through entities should not be called upon to make up the lost revenue from this change.

Additionally, the multifamily industry would be extremely concerned by proposals that would arbitrarily limit the ability of current and future pass-through entities to fully utilize lower tax rates and other benefits tax reform may provide. Specifically, we would be troubled by proposals that would force pass-through income to be taxed at both the entity and individual levels or that would subjectively deem only a portion of such income received to qualify for a business tax rate that may be lower than individual tax rates. In other words, all legitimate business income, regardless of source (but taking into account reasonable compensation rules), should be eligible for a preferential business income tax rate.

Priority 2: Retain the Full Deductibility of Business Interest

Under current law, business interest is fully deductible. However, efforts to prevent companies from overleveraging are in part leading to an examination of whether the current 100 percent deduction for business interest expenses should be curtailed. Unfortunately, curtailing this deductibility—either in whole or in part—would greatly increase the cost of debt financing necessary for multifamily projects, curbing development activity.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities, many of which do not have access to public equity markets. Although such entities can access some equity from investors that are largely private, they must generally borrow a significant portion of the funds necessary to fi-

[12] U.S. Census Bureau and U.S. Department of Housing and Urban Development, Rental Housing Finance Survey, 2015.

nance a multifamily development. A typical multifamily deal might consist of 65 percent debt and 35 percent equity. Indeed, according to the Federal Reserve, as of March 31, 2017, total multifamily debt outstanding was $1.21 trillion.[13] Reducing the full deductibility of interest would undoubtedly increase investment costs for owners and developers of multifamily housing and negatively impact aggregate construction.

Finally, in addition to the harm it would cause, there is little policy justification for curtailing interest deductibility for the multifamily industry. Multifamily real estate is generally not held through corporations. As a result, there is no preference in the tax code for debt over equity. In other words, corporations favor debt over equity because they are able to deduct interest but not dividends. That is simply not an issue for the pass-through entities that dominate the real estate industry. With no problem to be solved, there is no need to effectively penalize the multifamily industry.

Priority 3: Ensure Depreciation Rules Avoid Harming Multifamily Real Estate

Enabling multifamily developers to recover their investment through depreciation rules that reflect underlying economic realities promotes apartment construction, economic growth and job creation. Tax reform should ensure that depreciation tax rules are not longer than the economic life of assets by taking into account natural wear and tear and technological obsolescence.

In this regard, NMHC/NAA recommend that the Finance Committee consider a recent study that suggests the depreciation of multifamily buildings should certainly be no longer than the current-law 27.5-year period and perhaps shorter. In particular, David Geltner and Sheharyar Bokhari of the MIT Center for Real Estate in November 2015 published a paper, "Commercial Buildings Capital Consumption in the United States," which represents the first comprehensive study on this topic in nearly 40 years.[14] By including capital improvement expenditures, the MIT study finds that residential properties net of land depreciate at 7.3 percent per year on average, which is a significantly faster rate than previously understood. Translated into tax policy terms, *we believe this data shows that the current-law 27-5-year depreciation period overstates the economic life of an underlying multifamily asset by nearly 9 years.*

Additionally, a note is warranted regarding so-called deprecation recapture. Under current law, when a multifamily property is sold, there are two types of taxes that apply. First, gain from the sale of the property is taxed as a capital gain, typically at a rate of 20 percent for a general partner and 23.8 percent for a limited partner. Second, the portion of the gain attributable to prior depreciation deductions is generally subject to a 25 percent tax. This second tax is referred to as depreciation recapture.

NMHC/NAA believe that depreciation recapture taxes as they stand today can have a pernicious effect on property investment and should be made no worse. After decades of operations, many multifamily owners have a very low tax basis in their properties. If sold under current law, owners would have to pay large depreciation recapture taxes. To avoid this huge tax bill, many current owners of properties with low tax basis will not only avoid selling their properties, but they will also be reluctant to make additional capital investments in properties. The result is deteriorating properties that are lost from the stock of safe, affordable housing. The other alternative is for the long-time owners to sell their properties to an entity that is able to pay a large enough sales price to cover the recapture taxes. To make their investment pay off, however, the new owner will likely convert the property to higher, market-rate rents, meaning a loss of our nation's affordable housing stock.

Therefore, either scenario can have the same result: the possible loss of hundreds of thousands of affordable housing units. Increasing depreciation recapture taxes will exacerbate this result and further discourage owners from selling these properties to entities that can retain them as affordable housing.

Finally, the multifamily industry would like to commend Senators Thune and Roberts for introducing the Investment in New Ventures and Economic Success Today Act of 2017 or the INVEST Act of 2017 (S. 1144). By enhancing and making perma-

[13] Board of Governors of the Federal Reserve System, "Mortgage Debt Outstanding," by type of property, multifamily residences, 2017Q1, June 2017.
[14] David Geitner and Sheharyar Bokhari, MIT Center for Real Estate, "Commercial Buildings Capital Consumption in the United States," November 2015.

nent Section 179 small business expensing and 50 percent bonus depreciation, the bill would encourage multifamily firms to increase investment. We particularly support the bill's provision to modify current-law Section 179 rules to enable property used in rental real estate, such as appliances and furnishings, to qualify for this incentive.

While we support the INVEST Act of 2017, we would note that we would be extremely concerned if Congress opted to enact the measure while curtailing the full deductibility of business interest. This is particularly the case because while the INVEST Act is a worthy piece of legislation that would promote business investment, it does not accelerate the depreciation period of real property, including multifamily buildings. Additionally, depending on the details of final legislation, it may be the case that benefits gained from accelerated depreciation—even if it encompasses real property—could fall short of losses brought on by the curtailment of interest deductibility. The multifamily industry asks to work with the Finance Committee to ensure that tax reform—with all provisions taken as a whole—spurs investment rather than unintentionally impedes real estate activity.

Priority 4: Preserve the Ability to Conduct Like-Kind Exchanges

Since 1921, the Internal Revenue Code has codified the principle that the exchange of one property held for business use or investment for a property of a like-kind constitutes no change in the economic position of the taxpayer and, therefore, should not result in the imposition of tax. This concept is codified today in Section 1031 of the Internal Revenue Code with respect to the exchange of real and personal property,[15] and it is one of many non-recognition provisions in the Code that provide for deferral of gains.[16]

Like-kind exchanges play a significant role and are widely used in the multifamily industry. Current-law like-kind exchange rules enable the smooth functioning of the multifamily industry by allowing capital to flow more freely, which, thereby, supports economic growth and job creation. Multifamily property owners use Section 1031 to efficiently allocate capital to optimize portfolios, realign property geographically to improve operating efficiencies and manage risk. By increasing the frequency of property transactions, the like-kind exchange rules facilitate a more dynamic multifamily sector that supports additional reinvestment and construction activity in the apartment industry.

According to recent research by Drs. David C. Ling and Milena Petrova regarding the economic impact of repealing like-kind exchanges for real estate and the multifamily industry in particular:[17]

- Assuming a typical 9-year holding period, apartment rents would have to increase by 11.8 percent to offset the taxation of capital gains and depreciation recapture income at rates of 23.8 percent and 25 percent, respectively.

[15] Section 1031 permits taxpayers to exchange assets used for investment or business purposes, including multifamily properties, for other like-kind assets without the recognition of gain. The tax on such gain is deferred, and, in return, the taxpayer carries over the basis of the original property to the new property, losing the ability to take depreciation at the higher exchange value. Gain is immediately recognized to the extent cash is received as part of the like-kind exchange, and the taxes paid on such gain serve to increase the newly acquired property's basis. Congress has largely left the like-kind rule unchanged since 1928, though it has narrowed its scope.

The like-kind exchange rules are based on the concept that when one property is exchanged for another property, there is no receipt of cash that gives the owner the ability to pay taxes on any unrealized gain. The deferral is limited to illiquid assets, such as real estate, and does not extend to investments that are liquid and readily convertible to cash, such as securities. Furthermore, the person who exchanges one property for another property of like-kind has not really changed his economic position; the taxpayer, having exchanged one property for another property of like-kind is in a nearly identical position to the holder of an asset that has appreciated or depreciated in value, but who has not yet exited the investment.

[16] Under the tax code, the mere change in value of an asset, without realization of the gain or loss, does not generally trigger a taxable event. In such situations, the proper tax treatment is to defer recognition of any gain and maintain in the new property the same basis as existed in the exchanged property. This is similar in concept to other non-recognition, tax deferral provisions in the tax code, including property exchanges for stock under Section 351, property exchanges for an interest in a partnership under Section 721, and stock exchanges for stock or property under Section 361 pursuant to a corporate reorganization.

[17] David C. Ling and Milena Petrova, "The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate," June 2015.

- Whether based on the number of transactions or dollar volume, multifamily properties, both large and small, are the property type most frequently acquired or disposed of with an exchange.
- Nearly 9 in 10 (88 percent) of commercial properties acquired by a like-kind exchange result in a taxable sale in the very next transaction. Thus, like-kind exchange rules are not used to indefinitely defer taxes.
- Governments collect 19 percent more taxes on commercial properties sold following a like-kind exchange than by an ordinary sale.

Additional research suggests that like-kind exchanges play such a critical role in driving investment that repealing the ability to conduct them would harm the economy even if the resulting revenue were used to reduce tax rates. Indeed, Ernst and Young LLP estimates that repealing like-kind exchange rules and using the resulting revenue to enact a revenue-neutral corporate income tax rate reduction or a revenue-neutral business sector income tax reduction (*i.e.,* encompassing both C corporations and flow-through entities) would reduce Gross Domestic Product by $8.1 billion each year and $6.1 billion each year, respectively.[18] Put another way, a tax rate reduction financed by repealing like-kind exchange rules would, on a net basis, harm the economy.

Ernst and Young LLP summed up its analysis of how repealing like-kind exchanges would impair investment by concluding, "While repealing like-kind exchange rules could help fund a reduced corporate income tax rate, its repeal increases the tax cost of investing by more than a corresponding revenue neutral reduction in the corporate income tax rate and reduces GDP in the long run."[19] This result, of course, moves in the opposite direction of one of the stated goals for tax reform put forward by many of its proponents.

Priority 5: Maintain the Current Law Tax Treatment of Carried Interest

A carried interest, also called a "promote," has been a fundamental part of real estate partnerships for decades. Investing partners grant this interest to the general partners to recognize the value they bring to the venture as well as the risks they take. Such risks include responsibility for recourse debt, litigation risks and cost overruns, to name a few.

Current tax law, which treats carried interest as a capital gain, is the proper treatment of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue would be inappropriate and result in skewed and inconsistent tax treatment vis-à-vis other investments. Notably, any fees that a general partner receives that represent payment for operations and management activities are today properly taxed as ordinary income.

Taxing carried interest at ordinary income rates would adversely affect real estate partnerships. At a time when the nation already faces a shortage of affordable rental housing, increasing the tax rate on long-term capital gains would discourage real estate partnerships from investing in new construction. Furthermore, such a reduction would translate into fewer construction, maintenance, on-site employee and service provider jobs.

Notably, former House Ways and Means Committee Chairman Camp recognized the devastating impact that a change in the manner in which carried interest is taxed would have on commercial real estate when he specifically exempted real estate from a change he sought to the taxation of carried interest in his Tax Reform Act of 2014.[20]

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. Enacting a bad tax law, such as changing the taxation of carried interest, merely to gain revenue to make other tax changes, is a distorted view of good tax policy, which demands that each tax proposal be judged on its individual merits.

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[18] Ernst and Young LLP, "Economic impact of repealing like-kind exchange rules," March 2015 (revised November 2015).
[19] *Ibid.*
[20] H.R. 1, Tax Reform Act of 2014, Section 3621, Ordinary income treatment in the case of partnership interest held in connection with performance of services.

Priority 6: Preserve and Strengthen the Low-Income Housing Tax Credit

The Low-Income Housing Tax Credit (LIHTC) has a long history of successfully generating the capital needed to produce low-income housing while also enjoying broad bipartisan support in Congress. This public/private partnership program has led to the construction of nearly 3 million units since its inception in 1986.[21] The LIHTC program also allocates units to low-income residents while helping to boost the economy. According to a December 2014 Department of Housing and Urban Development study, "Understanding Whom the LIHTC Program Serves: Tenants in LIHTC Units as of December 31, 2012," the median income of a household residing in a LIHTC unit was $17,066[22] with just under two-thirds of residents earning 40 percent or less of area median income.[23] Finally, the National Association of Home Builders reports that, in a typical year, LIHTC development supports approximately: 95,700 jobs; $3.5 billion in federal, state and local taxes; and $9.1 billion in wages and business income.[24]

Maintaining and bolstering the LIHTC's ability to both construct and rehab affordable housing is critical given acute supply shortages. Indeed, the Harvard Joint Center for Housing Studies estimated that there were only 45 affordable units for every 100 very low-income households (those earning up to 50 percent of area median income) in the United States in 2015.[25]

The LIHTC has two components that enable the construction and redevelopment of affordable rental units. The so-called 9 percent tax credit supports new construction by subsidizing 70 percent of the costs. Meanwhile, the 4 percent tax credit can be used to subsidize 30 percent of the unit costs in an acquisition of a project or new construction of a federally subsidized project and can be paired with additional federal subsidies.

Developers receive an allocation of LIHTCs from state agencies through a competitive application process. They generally sell these credits to investors, who receive a dollar-for-dollar reduction in their federal tax liability paid in annual allotments, generally over 10 years. The equity raised by selling the credits reduces the cost of apartment construction, which allows the property to operate at below-market rents for qualifying families; LIHTC-financed properties must be kept affordable for at least 15 years, but, in practice, a development receiving an allocation must commit to 30 years. Property compliance is monitored by state allocating agencies, the Internal Revenue Service, investors, equity syndicators and the developers.

First and foremost, Congress should retain the LIHTC as part of any tax reform legislation. In so doing, Congress must take care to offset any reduction in equity LIHTC could raise attributable to a reduction in the corporate tax rate. Furthermore, NMHC/NAA reminds Congress that tax-exempt private activity multifamily housing bonds are often paired with 4 percent tax credits to finance multifamily development, and that such tax-exempt bonds should be retained in any tax reform legislation as they play a critical role in making deals viable to investors.

Second, Congress should also look to strengthen the credit by both increasing program resources so that additional units can be developed or redeveloped and making targeted improvements to the program to improve its efficiency. Congress could increase program authority by allocating additional tax credits. Additionally, a part of the LIHTC that could benefit from a targeted adjustment involves program rules that require owners to either rent 40 percent of their units to households earning no more than 60 percent of area median income (AMI) or 20 percent to those earning no more than 50 percent of AMI. If program rules were revised to allow owners to reserve 40 percent of the units for people whose average income is below 60 percent of AMI, it could serve a wider array of households.

In this regard, the multifamily industry strongly supports the Affordable Housing Credit Improvement Act of 2017 (S. 548) and commends Senators Cantwell and Hatch for its introduction. We also thank Finance Committee Senators Wyden, Ben-

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[21] National Council of State Housing Agencies, "2016 Housing Credit FAQ," February 25, 2016, *https://www.ncsha.org/resource/2016-housing-credit-faq.*

[22] Department of Housing and Urban Development, "Understanding Whom the LIHTC Program Serves: Tenants in LIHTC Units as of December 31, 2012," December 2014, p. 23.

[23] *Ibid,* p. 24.

[24] Robert Dietz, "The Economic Impact of the Affordable Housing Credit," National Association of Home Builders, *Eye on Housing,* July 15, 2014, *http://eyeonhousing.org/2014/07/the-economic-impact-of-the-affordable-housing-credit/.*

[25] NMHC tabulations of 2015 American Community Survey public use microdata, IPUMS–USA, University of Minnesota, *www.ipums.org.*

net, Heller, Isakson, and Portman for their cosponsorship. Finally, we would also urge the Committee to strongly consider the Middle-Income Housing Tax Credit Act of 2016 (S. 3384) that Ranking Member Wyden introduced during the 114th Congress to address the shortage of workforce housing available to American households. We believe that this bill would be a worthy complement of measures to expand and improve LIHTC.

Priority 7: Preserve the Current Law Estate Tax

As part of the American Taxpayer Relief Act of 2012 (Pub. L. 112–240), Congress in January 2013 enacted permanent estate tax legislation. The Act sensibly made permanent the $5 million exemption level (indexed for inflation) enacted as part of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Pub. L. 111–312) and set a top tax rate of 40 percent. Crucially, it also retained the stepped-up basis rules applicable to inherited assets. As many apartment executives prepare to leave a legacy to their heirs, it is vital to have clarity and consistency in the tax code with regard to estate tax rules. For this reason, the apartment industry remains supportive of the permanent estate tax legislation passed in early 2013.

There are three key elements to the estate tax: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements can be important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- *Exemption Levels:* The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. In 2017, there is a $5.49 million exemption.
- *Tax Rates:* The estate tax rate applies to the value of an estate that exceeds the exemption level. The maximum rate is 40 percent.
- *Basis Rules:* The basis rules determine the tax basis to the recipient of inherited property. There are generally two different ways that basis is determined-stepped-up basis and carryover basis. The estate tax today features stepped-up basis rules, and under this regime, the tax basis of inherited property is generally reset to reflect the fair market value of the property at the date of the decedent's death. By contrast, under carryover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor. This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Retaining a stepped-up basis rule is critical for estates that contain significant amounts of depreciated real property as it helps heirs reduce capital Gains taxes and maximize depreciation deductions.

Priority 8: Reform the Foreign Investment in Real Property Tax Act to Promote Investment in the Domestic Apartment Industry

The Foreign Investment in Real Property Tax Act (FIRPTA) (Pub. L. 96–499) serves as an impediment to investment in U.S. commercial real estate, including multifamily housing. The FIRPTA regime is particularly pernicious because it treats foreign investment in real estate differently than investment in other economic sectors and, thereby, prevents commercial real estate from securing a key source of private-sector capital that could be used to develop, upgrade, and refinance properties.

Congress should enact/tax reform that either repeals FIRPTA or, at the very least, further mitigates its corrosive effect on foreign investment in U.S. real estate. Notably, a recent study finds that repealing FIRPTA would increase international investment in U.S. real estate by between $65 billion and $125 billion while generating between $26 billion and $49 billion in economic activity and creating between 147,000 and 284,000 direct and indirect jobs.[26]

Under current law, the U.S. does not generally impose capital gains taxes on foreign investors who sell interests in assets sourced to the U.S. unless those gains are effectively connected with a U.S. trade or business. This means that a foreign investor generally incurs no U.S. tax liability on capital gains attributable to the sale of stocks and bonds in non-real estate U.S. companies.

FIRPTA, however, serves as an exception to the general tax rules and imposes a punitive barrier on foreign investment in U.S. real estate. Under FIRPTA, when a foreign person disposes of an interest in U.S. real property, the resulting capital

[26] Kenneth T. Rosen, Randall Sakamoto, David Bank, Brett Fawley, Adam Eckstein, and Michael Stern, "Unlocking Foreign Investment in U.S. Commercial Real Estate," June 2017.

gain is automatically treated as income effectively connected to a U.S. trade or business. Thus, the foreign investor is subject to a withholding tax on the proceeds of the sale only because it is associated with an investment in U.S. real estate.

In addition to levying tax, FIRPTA mandates onerous administrative obligations that further deter foreign investment in U.S. real estate. First, the buyer of a property must withhold 15 percent of the sales price of a property sold by a foreign investor so as to ensure taxes are collected. Second, if they overpay tax through the withholding, foreigners investing in U.S. real estate must file tax returns with the IRS to receive a refund of the overpayment.

The taxes and administrative burdens FIRPTA imposes have negative consequences for U.S. commercial real estate and the multifamily industry. Because foreign investors can avoid U.S. tax and reduce their worldwide tax burden tax by investing in U.S. securities or in real estate outside of the U.S., they may simply choose not to invest in U.S. real estate. This is particularly harmful to an apartment industry that relies on capital to finance and refinance properties. Furthermore, because it is the sale of a U.S. property interest that triggers FIRPTA, foreign investors may hold on to U.S. real estate solely for tax considerations.

Repealing FIRPTA would ensure that tax considerations will not prevent capital from flowing to the most productive investments. Such reform could unlock billions in foreign capital that could help to both drive new investment and refinance real estate loans. If outright repeal proves impossible, Congress should consider additional targeted reforms to the FIRPTA regime. NMHC/NAA were particularly pleased that Congress in late 2015 enacted legislation to both provide a partial exemption from FIRPTA for certain stock of real estate investment trusts and exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests.[27]

Conclusion

NMHC/NAA look forward to working with the Finance Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. In communities across the country, apartments enable people to live in a home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice. We stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide.

National Retail Federation (NRF)
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September 19, 2017

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

Re: Hearing on "Business Tax Reform"—September 19, 2017

Dear Chairman Hatch and Ranking Member Wyden:

The National Retail Federation (NRF) strongly supports comprehensive reform of the federal income tax by lowering tax rates and broadening the tax base. Tax reform is vitally important to the U.S. economy and to retailers specifically, as consumer spending constitutes more than two-thirds of the U.S. economy. The U.S. economy cannot thrive when we have the highest corporate tax rate in the industrialized world. Income tax reform can have an immediate positive impact on economic growth, real wages and consumer spending. The NRF is opposed to efforts to shift the tax burden from businesses to consumers.

[27] Public Law 114–113, Consolidated Appropriations Act, 2016, Division Q, Protecting Americans from Tax Hikes Act of 2015.

By way of background, NRF is the world's largest retail trade association, representing discount and department stores, home goods and specialty stores, Main Street merchants, grocers, wholesalers, chain restaurants and Internet retailers from the United States and more than 45 countries. Retail is the nation's largest private-sector employer, supporting one in four U.S. jobs—42 million working Americans. Contributing $2.6 trillion to annual GDP, retail is a daily barometer for the nation's economy.

NRF supports business income tax reform that eliminate tax credits and incentives that favor some industries over others, and supports replacing these "tax expenditures" with substantially lower tax rates, freeing businesses to make the most economically prudent investment decisions rather than having the tax code drive decision-making. Business tax reform should be neutral among different types of businesses, so that businesses are not favored based on their form of legal entity (*e.g.,* C corporation vs. pass-through), how they own their property (*e.g.,* leased stores vs. owned stores), or distribution channel (*e.g.,* brick and mortar sale vs. remote sale). In addition, tax reform should provide adequate transitions rules, so that businesses do not face large tax burdens based on investment decisions made in years prior to the enactment of tax reform.

A substantial reduction in the high U.S. corporate tax rate will drive economic growth. Because the U.S. corporate tax rate is the highest in the industrialized world, U.S. companies are choosing to make more investments outside of the United States and foreign companies are choosing to make more investments in countries with lower corporate tax rates rather than the United States, where they can achieve a better return on their investment (ROI). In 2016, the average statutory foreign corporate income tax rate in the OECD was 24.7% and several countries have enacted laws that schedule additional rate cuts over the next few years. Meanwhile, the United States has the highest statutory corporate tax rate in the OECD at 35% and when average state corporate taxes are added in that rate rises to almost 39%. According to an NRF analysis, in 2015 corporate taxes cost American workers up to $4,690 in wages.

The United States has not reduced its corporate tax rate in more than 30 years. At the same time other industrialized nations have reduced their tax rates and in some cases, multiple times. Americans cannot sit by any longer and watch other nations continue to reduce corporate tax rates and attract our businesses and jobs. We must compete for this investment in our country and our workers.

The National Retail Federation urges the Finance Committee to work expeditiously on tax reform and offers our full support in this endeavor.

Sincerely,

David French
Senior Vice President
Government Relations

NONPROFIT DATA PROJECT
Aspen Institute
One Dupont Circle, NW, Suite 700
Washington, DC 20036

ELECTRONIC FILING OF THE FORM 990 WILL INCREASE NONPROFIT TRANSPARENCY AND ACCOUNTABILITY, WHILE SAVING TAXPAYER MONEY

Thank you for this opportunity to submit a statement for the record on business tax reform. The Nonprofit Data Project of the Aspen Institute's Program on Philanthropy and Social Innovation brings together the major nonprofit research and data providers in the United States, including the Foundation Center, GuideStar, the Indiana University Lilly Family School of Philanthropy, and the Johns Hopkins Center for Civil Society Studies.

The Nonprofit Data Project writes to strongly support electronic filing of the Form 990 by all nonprofit organizations that file, and the release of these data in an open, machine-readable format by the Internal Revenue Service (IRS) to increase transparency and save taxpayer money.

This non-controversial, revenue-neutral provision (as rated by JCT) has been embraced by lawmakers on both sides of the aisle. It has been included in the:

- CHARITY Act of 2017, introduced by Senators John Thune and Bob Casey and co-sponsored by Senators Ron Wyden, Pat Roberts, and others;
- Taxpayer Protection Act of 2016, marked up by the Senate Finance Committee in April 2016;
- Business Income Tax Bipartisan Tax Working Group report, published by the Senate Finance Committee in 2015;
- Taxpayer Bill of Rights Enhancement Act of 2015, sponsored by Senators Thune and Grassley;
- Tax Reform Act of 2014, introduced by the former Chair of the House Ways and Means Committee, Representative David Camp; and
- Presidential budgets, from FY 2014–2017.

We urge you to make this commonsense proposal a part of business tax reform.

WHY 990 E-FILING MATTERS

The nonprofit sector is an invaluable resource in our society. Not only does the sector help millions of individuals in need, it represents 5 percent of the nation's gross domestic product (GDP) and is a major source of jobs. According to the Bureau of Labor Statistics, nonprofits account for over 10% of all private sector employment.

One of the best sources of information on nonprofits is the Form 990, which most nonprofit organizations are required to file annually with the IRS and make publicly available upon request. Current law already requires very large nonprofit organizations (those that file at least 250 returns during the calendar year and have over $10 million in assets) and very small nonprofit organizations (those with gross receipts of less than $50,000 annually) to file their tax returns electronically. Those in between are not subject to this requirement.

Until last year, the IRS made 990 forms available to the public by providing images of them in TIF format (Tagged Image File) via DVDs. A year's worth of 990s, both e-filed and paper-filed, cost over $2,000. Once purchased, the image-based 990s had to be re-processed to render them searchable, a practice that was not only expensive and inefficient, but also delayed access to the information and increased the potential for errors and omissions.

In June 2016, the IRS—in response to a federal lawsuit—began releasing electronically filed Form 990s as open, machine-readable data for free to Amazon Web Services. Today, this covers approximately 60% of all Form 990s. The remaining 40% of 990s are still paper-filed and are not released as open data.

The benefits of universal e-filing and open nonprofit data include:

- **Increased Transparency:** Nonprofit leaders, donors, businesses, policymakers, and the public can make better decisions, understand trends in the field and gauge where some nonprofits stand in comparison to their peers.
- **Improved Efficiency/Cost-Reductions:** Electronic filing lowers the cost of processing returns, saving the IRS and taxpayer money, while also enabling the agency to use resources more efficiently.
- **Reduction of Fraud:** E-filing makes it easier to detect and locate potential problems through computer analysis. More timely and accessible data will not only help the IRS and state charity officials address compliance concerns (as the National Association of State Charity Officials has noted), but it will also boost the public's ability to monitor charities. Furthermore, the Advisory Committee on Tax Exempt and Government Entities (ACT) observed in its 2015 report that the IRS utilized less than half of the information from the Form 990 for data analytics functions, due to the constraints of manually entering data from paper forms. Electronic filing by all nonprofits will result in more information being available for electronic review, and thus higher utilization of 990 data for tax compliance and analytical purposes.
- **Improved Accuracy/Reduced Errors:** E-filed returns, as opposed to paper-filed returns, reduce inaccurate calculations and cut down on mistakes. Fewer errors and better front-end identification of such errors also reduce taxpayer burden in the filing process.
- **More Innovation/Business Opportunities:** Entrepreneurs and innovators will have data available to develop new, useful "apps" and products that can help solve problems in our communities and contribute to the economy.

- **Improved Information for the Public:** The development of tools that use, aggregate and combine Form 990 data with other data sets can provide a wealth of information, such as, pinpointing nonprofit trends, tracking the flow of philanthropic giving relative to need, and determining how the nonprofit sector impacts local economies.

CONCLUSION

We thank the Senate Finance Committee for its past support and appreciate this opportunity to submit a statement for the record on business tax reform. Adoption of mandatory Form 990 e-filing coupled with the release of the forms as open, machine-readable data will benefit the public and the nonprofit sector, while strengthening law enforcement and enhancing sector wide accountability.

Please contact Cinthia Schuman Ottinger at cschuman@aspeninst.org for further information about Form 990 e-filing or the Nonprofit Data Project of the Aspen Institute.

Sincerely,

Nonprofit Data Project of the Aspen Institute

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Written Testimony of Dr. Elaine C. Kamarck and James P. Pinkerton Co-Chairs

Thank you, Chairman Hatch and Ranking Member Wyden, for convening this critical hearing today on America's broken business tax system.

It's a simple fact that at 35 percent, the U.S. has the highest statutory corporate tax rate in the industrialized world. Indeed, our combined state and federal corporate tax rate of 39.1 percent is almost 50 percent higher than the OECD average of 24.1 percent. Yet, the rub comes when we compare the statutory tax rate with the effective tax rate. And here we sometimes see a dramatic difference. That is, despite the high "sticker rate," some corporations are paying an effective rate in the single-digit range, sometimes, even, zero—or less.

Conversely, most corporations—especially those with mostly domestic operations—pay a much higher rate. That is, up there in the 30s, well beyond the international average.

It's this discrepancy—this unfairness—between tax rates that helps animate the drive for tax reform, including corporate tax reform.

To put it bluntly, it's crazy to let some companies pay tax at well below the international average, and others pay tax at well above the international average.

Companies that exploit our broken system to avoid paying taxes through loopholes should pay their fair share. Americans deserve the kind of reform that makes single digit—even zero—percent tax rates a thing of the past.

Yet, at the same time, many American companies—both large and small—are paying abundantly more than their fair share. As such, it is clear that America's business tax system is broken.

As Washington prepares to consider the high cost of that broken tax system on businesses of all sizes and the workers they employ across the country, we are guided by a fundamental belief that America cannot continue to allow a higher tax rate to lower our position in today's globalized marketplace.

We have therefore made it our mission to reform the tax code by reducing the corporate income tax rate. Here's why:

- A September 2017 analysis conducted by the National Retail Federation found that high corporate tax rates push down wages of the average corporate worker by as much as $4,690 annually.
    - The NRF found that in 2015, workers bore between $86 billion and $257 billion of the corporate tax burden.

- A September 2017 report by the Heritage Foundation found that “the corporate income tax harms workers through lower wages.”
- A 2015 NRF analysis conducted by EY found that the failure to reduce the U.S. corporate tax rate costs U.S. families $3,000 a year in spending power.
- A March 2013 study conducted by EY found that in the long run, the U.S. economy, as measured by U.S. GDP, would be smaller by between 1.5% and 2.6% if the current corporate income tax rates remain in place (equivalent to a reduction in U.S. GDP of roughly $235 billion to $345 billion each year.)
- A 2015 Business Roundtable report conducted by EY found that with a 25% tax rate, U.S. companies would have acquired $590 billion in cross-border assets over the past 10 years instead of losing $179 billion in assets—a net shift of $769 billion in assets from foreign countries to the United States.
  - The report also found that a 25% tax rate would have kept 1,300 companies in United States.
- A January 2015 National Association of Manufacturers study found that over a 10-year period, a pro-growth tax reform plan would increase GDP by more than $12 trillion relative to CBO projections, increase investment by more than $3.3 trillion, and add more than 6.5 million jobs to the U.S. economy.
- A September 2012 analysis by the American Action Forum estimated that a comprehensive tax reform plan that includes a move to a territorial tax system, with a statutory tax rate of at least 25% (revenue neutral—inclusive of growth effects) would lift economic growth by 1 percentage point. In the near term, this would translate to roughly 1 million more jobs.
- A 2015 simulation conducted by the Tax Foundation’s TAG Model found that our GDP would increase by 3.3% or 4.3% if our corporate income tax rate mirrored the levels enjoyed in the UK and Canada respectively.

Put simply: Because American companies are paying the highest corporate tax rate in the industrialized world, the American worker is paying a steep price in the form of lower wages and lost opportunities. As a result, our federal government isn’t just collecting taxes—it is also constricting our economy by keeping it on the wrong side of a global zero-sum game in which our loss can become quite literally any other country’s gain.

It is therefore long past time to enact meaningful tax reform with a rate that is as competitive as our spirit—one that unleashes, not undercuts, American prosperity. The bipartisan resolve in your Committee and among your colleagues to seize this once-in-a-generation opportunity is a telling testament to the importance of doing so.

As more and more American businesses flee to more economical shores overseas, our global competitors—each and every country the world over—aren’t just counting on Washington’s continued inaction—they’re hoping for it.

Let’s prove them wrong by doing right by the American worker.

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Introduction

The R&D Credit Coalition appreciates the opportunity to provide comments to the Senate Finance Committee as part of the hearing on “Business Tax Reform.” The R&D Credit Coalition is a group of trade and professional associations along with small, medium and large companies that collectively represent millions of American workers engaged in U.S.-based research throughout major sectors of the U.S. economy, including aerospace, agriculture, biotechnology, chemicals, electronics, energy, information technology, manufacturing, medical technology, pharmaceuticals, software and telecommunications. The Coalition welcomes the opportunity to provide comments regarding incentives for research and development.

Although the R&D Credit Coalition is diverse, the member companies which the coalition represents share a major characteristic: they collectively spend billions of dollars annually on research and development, which provides high-wage and highly skilled jobs in the United States. The high U.S. corporate income tax rate and, until recently, the temporary nature of the U.S. R&D tax credit, compared to the lower corporate income tax rates and more stable and robust research incentives in most other developed countries, are key factors that companies consider in determining where they are going to create and maintain R&D jobs.

Under current law, a taxpayer can deduct the cost of research expenses in the year incurred (Section 174 of the Internal Revenue Code (hereinafter referred to as "the Code")). In addition, the tax code provides an incremental R&D tax credit for up to 20% (14% under an easier to calculate elective Alternative Simplified Credit ("ASC")) of qualified research costs over a base amount; 20% of "basic research" payments; and 20% for amounts for energy research (Section 41 of the Code). However, if the taxpayer elected to utilize the R&D tax credit, the taxpayer's deduction is reduced by the amount of any R&D tax credit (Section 280C of the Code). For 2016 and beyond, certain small business taxpayers can claim the R&D credit against their Alternative Minimum Tax liability and qualified small businesses can use their R&D credit to offset a portion of their payroll tax liability, subject to limits.

The Coalition believes that the U.S. economy has benefited greatly from tax policies, such as the deduction under Section 174 and the R&D tax credit under Section 41, that incentivize investments in innovative research activities that create new and higher wage jobs. These investments and the innovations and advancements derived from the research have beneficial spillover effects to the economy and society. The Coalition strongly believes Congress should support a strengthened and permanent R&D tax credit as well as continue with the current law practice of allowing R&D costs to be deducted in the year incurred.

In particular, the Coalition has strongly advocated for bipartisan legislation in both the Senate and House to make the R&D tax credit permanent and increase to 20% the ASC. The Coalition appreciates the longstanding support of Chairman Hatch, Ranking Member Wyden, and other Finance Committee members for the R&D tax credit. The Coalition is pleased that the Congress, with the enactment of the PATH Act (Pub. L. 114–113), permanently extended the current law R&D credit to provide much needed certainty to taxpayers engaged in research activities. In addition, the Coalition supports legislation introduced in the 115th Congress by Representatives Pat Tiberi (R–OH) and John Larson (D–CT), the Research and Experimentation Advances Competitiveness at Home (REACH) Act of 2016 (H.R. 2821), to increase the ASC to 20% and make needed clarifications to the credit to ease the administration and compliance of the credit for both taxpayers and the IRS.

As the Administration and Congress consider tax reform alternatives, the Coalition recommends adopting proposals, such as H.R. 2821, that make the credit more effective at incentivizing additional research activities and rejecting proposals that would limit or hinder companies from making research investments.

The R&D tax credit is a proven incentive to maintain and create high-paying jobs and stimulate positive economic benefits. The Coalition recommends increasing the ASC rate from 14% to 20% as a means to both enhance the benefits of the credit and improve efficiency and credit compliance. The calculation for the ASC is much simpler for taxpayers to comply with compared to the regular credit and using the ASC would help improve credit administration. Importantly, given that Congress has made the regular credit option and the ASC option permanent, providing parity for both options at a 20% rate would enhance the incentive effect of the credit.

Additionally, the Coalition is concerned about proposals that would reduce the attractiveness of investing in U.S. research projects such as previous proposals to limit the use of the R&D tax credit or require lengthy amortization of research costs.

Discussion

The Coalition appreciates that an objective of tax reform is to achieve a reduction in the corporate statutory rate and balance the rate reduction with offsetting reforms. Reducing the U.S. corporate tax rate from the highest in the world is a necessary reform to enhance the competitiveness of U.S. based businesses and to attract investment. In today's global economy with greater demand for investment in research activities, there is significant global competition for R&D jobs. Companies have an array of choices on where to locate such jobs and where to invest research dollars as many countries have highly educated and skilled workforces. It is clear that investments in research and innovation have positive spillover effects in the U.S. economy. Likewise, tax or other incentives to attract that investment enhance those spillover effects.

With increased global competition, it is vital to ensure that the United States is the best place for companies to do business and conduct research. There are many other countries that offer *both* lower corporate tax rates and more attractive R&D incentives.[1] For example, Australia provides a 40% tax credit for all eligible R&D expenditures and a corporate tax rate of 30%. If the United States is to retain and attract global R&D activities across all sectors of the economy, there is a growing need for the certainty provided by a tax code that is favorable to R&D investment. Retaining current year expensing and providing a strengthened R&D tax credit would enhance the attractiveness of the United States for investment and stimulate job creation to grow the economy and keep the U.S. competitive.

R&D Tax Credit as an Economic Incentive

The United States must maintain a globally competitive tax system that supports high-skilled, high-paying jobs. The R&D tax credit, originally enacted in 1981, was designed to be an important incentive in spurring private sector investment in innovative research by companies of all sizes and in a variety of industries. The enactment of this incentive helped establish the United States as a world leader in cutting-edge research that created high-paying jobs here in the United States. During the 1980s, the United States was the leader among OECD countries in providing the best R&D incentives for companies. However, in recent years, many other countries have instituted more generous R&D incentives. For example, South Korea has a 40% tax credit for current year R&D spending that exceeds the 3-year average and Canada has a 15% tax credit for *all* eligible R&D spending. As a result, according to an OECD study in 2016, the United States ranked 25th for large firms and 26th for small and medium-sized enterprises in research incentives among industrialized countries.[2]

Several OECD countries have enacted a variety of tax incentives to attract research activities, including tax credits that can be as high as 50% of research expenses, super deductions that can be as high as 300% of research expenses, extending the credit to providers of contract research services, as well as other incentives to encourage research spending.[3] A National Science Board report concluded that the United States' lead in science and technology is "rapidly shrinking" as R&D jobs and overall R&D spending continue to increase faster outside the United States than here at home. The report shows that "between 1999 and 2009 . . . the United States share of global research and development (R&D) dropped from 38 percent to 31 percent, whereas it grew from 24 percent to 35 percent in the Asia region during the same time."[4]

The R&D tax credit has a significant impact on private R&D spending and the creation of valuable research jobs. According to a study by Ernst and Young (EY), "In total, the overall policy—the existing credit plus strengthening the ASC—is estimated to increase annual private research spending by $15 billion in the short term and $33 billion in the long term."[5] Moreover, it is important to note that the R&D tax credit is largely a *jobs* credit—70 percent of credit dollars are used to pay the salaries of high-skilled R&D workers in the United States. The EY study also stated that, "the credit and its enhancement is estimated to increase research-related employment by 140,000 in the short term and 300,000 in the long term."[6]

The Coalition supports a permanent R&D credit that strengthens the ASC to 20 percent to encourage more domestic innovation, job creation, economic growth, and to enhance U.S. competitiveness. Along with enhancing the credit, current eligibility for the types of research expenditures that qualify for the credit must be retained.

For example, software development activities contribute billions of dollars to the U.S. economy and employ millions of highly skilled workers. Companies, universities and other organizations spend billions of dollars a year in research activities to develop new computer software and create new applications for existing software that is innovative. Software development is a critical component of numerous products and services and is critical to just about every industry segment, including medical, manufacturing, automotive, aerospace and defense, telecommunications, and others. In particular, software is a key element in advanced manufacturing and

[1] Deloitte, "Global Survey of R&D Tax Incentives," December 2015.

[2] OECD, "Measuring Tax Support for R&D and Innovation," *http://www.oecd.org/sti/rd-tax-incentive-indicators.htm;* ITIF, "Why Expanding the R&D Tax Credit is Key to Successful Corporate Tax Reform," July 2017.

[3] Deloitte, "2017 Survey of Global Investment and Innovation Incentives," March 2017.

[4] National Science Foundation press release, "New Report Outlines Trends in U.S. Global Competitiveness in Science and Technology," January 17, 2011.

[5] Ernst and Young, "The R&D Credit: An effective policy for promoting research spending," September 2011, p. i.

[6] Ernst and Young, "The R&D Credit: An effective policy for promoting research spending," September 2011, p.11.

the United States is a leader in software development. The Coalition recommends that research expenditures related to the use and development of computer software continue to be treated as qualified research expenditures eligible for the credit.

In addition, research activities require people, mainly highly skilled scientists, to conduct research, but also require testing equipment, raw materials, instruments, and a variety of inputs necessary to carry out the process of experimentation. Since the original enactment of the credit, Congress has recognized that supplies can be an integral part of conducting scientific research and thus are treated as qualified research expenses. While it has been clear that supplies qualify for the credit, the lack of clear guidance on the issue has created uncertainty in complying with the credit. Recent guidance has helped to clarify the prior uncertainties regarding the treatment of supplies. Given this history and the fact that companies must continually invest in process and product improvements to maintain competitiveness in the worldwide market, the Coalition recommends that research expenditures related to supplies continue to be treated as qualified expenditures eligible for the credit.

Section 174 Deduction

In enacting section 174 to allow research costs to be deducted in the year incurred, "Congress was pursuing two related objectives. . . . One was to encourage firms to invest more in R&D than they otherwise would. The second objective was to eliminate or lessen the difficulties, delays, and uncertainties encountered by businesses seeking to write off their research expenditures. . . ."[7] Expensing R&D costs reflects the tax and accounting realities inherent in bringing a new product to market. With R&D, amounts are expended to create an asset with a future benefit. In most other instances this would result in the capitalization and recovery through amortization of such costs. The inherent issue with expenses incurred in research and development is whether an asset of any value is being (or will be) created. At the time the amounts are expended, such a determination is often impossible. Further, research and development costs usually are incurred with the goal of creating a new or improved product, service, process or technique, but more often than not, the efforts do not result in success. As such, U.S. Generally Accepted Accounting Principles ("GAAP") do not require the capitalization and amortization of R&D costs on company financial statements.

Continuing the expensing of research costs is consistent with the proposals put forward to allow all investment costs to be immediately expensed. Proposals to limit the ability of companies to deduct the costs of U.S. based research activities for tax purposes will act as a disincentive to research investment, particularly for small firms with limited cash flow, some of which may not benefit from the credit and further risks the movement of investments and jobs abroad.

The Coalition believes that, given the inherent uncertainly around experimental research, these costs should continue to be allowed to be immediately expensed as under current law.

Conclusion

R&D incentives, such as the R&D tax credit and the expensing of research costs, are designed to ensure that companies from varied industries, including manufacturers and services businesses, conduct their research activities in the United States and create highly paid, highly skilled jobs. The original purpose of the tax credit still holds true today. It is vitally important that U.S. policy makers support proposals that enhance the attractiveness of the United States as a place to invest in research activities. A strengthened research and development tax credit, such as increasing the ASC to 20%, that is enacted as soon as possible and the continued ability to deduct research expenses are critical to competitiveness, innovation and U.S. jobs. In the global economy many companies have a choice as to where they are going to do their research—and with many other countries offering *both* lower corporate income tax rates and more robust R&D incentives, the U.S. tax system must provide globally competitive R&D incentives that can be counted on by businesses. Broad and sweeping changes to the tax credit that leave out innovative research activities and diminish the value of the credit reduce its effectiveness. The R&D Credit Coalition looks forward to assisting the Administration and Congress in gaining a more detailed understanding of the competitive pressures faced by companies as well as of the research and development tax credit and its impact on U.S. jobs. We also look forward to working together to advance legislation to enhance the U.S. po-

[7] Senate Budget Committee, "Tax Expenditures, Compendium of Background Material on Individual Provisions," 2012, p. 90 (The Compendium).

sition as an attractive location for investment and a leader in research and innovation.

Links to Studies:

Ernst and Young, "The R&D Credit: An effective policy for promoting research spending," *http://www.investinamericasfuture.org/PDFs/EY_R&D_Credit_Report_2011_09_16.pdf.*

OECD, "Measuring Tax Support for R&D and Innovation," *http://www.oecd.org/sti/rd-tax-incentive-indicators.htm.*

ITIF, "Why Expanding the R&D Tax Credit is Key to Successful Corporate Tax Reform," July 2017, *https://itif.org/publications/2017/07/05/why-expanding-rd-tax-credit-key-successful-corporate-tax-reform.*

Deloitte, "2017 Survey of Global Investment and Innovation Incentives," *https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-surveyof-global-investment-and-innovation-incentives.pdf.*

National Science Foundation press release, "New Report Outlines Trends in U.S. Global Competitiveness in Science and Technology," *http://www.nsf.gov/nsb/news/news_summ.jsp?cntn_id=122859&org=NSB&from=news.*

OECD, Ministerial Report on the OECD Innovation Strategy, May 2010, *http://www.oecd.org/dataoecd/51/28/45326349.pdf.*

OECD, "Science, Technology, and Industry Scoreboard," October 2015, *http://www.oecd.org/sti/scoreboard.htm.*

U.S. Department of the Treasury, "Investing in U.S. Competitiveness: The benefits of Enhancing the Research and Experimentation (R&E) Tax Credit," *http://www.investinamericasfuture.org/PDFs/TreasuryRDReportMarch25.PDF.*

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The Retail Industry Leaders Association (RILA) applauds the Committee for holding this hearing on business tax reform and welcomes this opportunity to express our strong support for the enactment of comprehensive tax reform. We appreciate your leadership and that of the Committee as you engage on the critical work to enact comprehensive tax reform.

RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs, and more than 100,000 stores, manufacturing facilities, and distribution centers located both domestically and abroad.

The retail industry supports more than 42 million American jobs. With more than $553 billion in labor income and more than $3.8 trillion in sales, retail is one of America's most powerful economic engines. In fact, consumer spending represents two-thirds of U.S. gross domestic product (GDP).

Addressing Global Anti-Competitiveness Faced by U.S. Companies

Retailers have long supported comprehensive tax reform that will benefit industry and consumers alike. We continue to call for a significant reduction in the corporate tax rate with a fresh scrutiny of all deductions and credits in the code, particularly ones that are not applicable to all taxpayers.

American companies are at a huge competitive disadvantage with our international competitors. This is directly a result of the U.S. statutory corporate tax rate being extremely high by international standards. The U.S. top combined federal and average state corporate income tax rate of 38.9 percent is the highest among the 35 member countries of the Organisation for Economic Co-operation and Development (OECD) and is 14.7 percentage points above the OECD average of 24.2 percent. In fact, the U.S. corporate tax rate is the third highest among countries throughout the world. Furthermore, the United States stands virtually alone among countries in taxing companies on their worldwide income rather than just on income earned domestically.

The retail industry's treatment under the current tax code belies its prominent place in the economy and stifles job creation, investment, and consumer spending/savings. A few years ago, RILA commissioned PricewaterhouseCoopers (PwC) to conduct a study on the tax rates paid by the retail industry. The study, entitled "U.S. Retail Trade Industry: Employment, Taxes, and Corporate Tax Reform," concluded that the retail industry's effective tax rate of 36.4 percent is the fourth highest domestic effective tax rate of all the 18 major U.S. industrial sectors—nearly 10 percentage points higher than the average rate.

The high effective tax rate imposed on the retail industry largely undermines U.S. competitiveness. A growing number of U.S. retailers are expanding into the global marketplace through the establishment of both retail operations in other countries as well as subsidiaries that strengthen the supply chain of goods and services they provide to their customers in this country. Our current system in the U.S. of taxing worldwide income not only constrains a retailer's ability to grow but also costs the U.S. well-paying jobs that a company must add to oversee such global operations.

Similarly, foreign-based retailers are entering the U.S. market with advantages over U.S. businesses due to a favorable tax structure in their home country. While these foreign-based companies compete on a level playing field in the United States, the favorable tax conditions under which they operate in their home country ease the task of generating profits there, and those profits are in turn invested in U.S. expansion and aggressively competing with U.S. based retailers.

To improve U.S. international competitiveness, RILA supports comprehensive tax reform that includes the following principles: significantly reduces the corporate tax rate; eliminates special credits and deductions in the code that favors some industries at the expense of others; addresses the tax rules applicable to all business types, as well as to individuals; simplifies and stabilizes the tax code; and institutes a territorial tax system, where the U.S. taxes corporate income earned only in the United States.

In addition, RILA is opposed to any limitation on the deduction for business interest expense. Businesses, large and small alike, borrow to finance their operations. The tax code has long recognized this, treating interest expense as an "ordinary and necessary" deductible business expense. Some have argued that interest expense should be eliminated and "traded" for 100 percent expensing of capital equipment. This misses the key point that expensing is an accounting/timing difference while the interest deduction has a permanent impact on financial statements for companies and ensures the proper measurement of income.

Retail Sector's Role in the Economy and in the Community

There are few industries that have a greater impact on the United States economy than retail. The retail industry employs millions of Americans throughout the supply chain and provides American consumers with the products they want to buy at the price they want to pay on demand. Retailers pay billions of dollars in federal, state, and local taxes each year, and collect and remit billions more in sales taxes to state and local governments. Brick and mortar retailers, large and small, provide a significant tax base for core local and state services such as police, fire and rescue, and schools.

According to the September Bureau of Labor Statistics jobs report, 87,000 retail workers lost their jobs so far in 2017. In addition, over 5,000 stores have closed or will close in 2017, an increase of 165 percent compared to last year. Given the enormous employment footprint of the retail industry, comprehensive tax reform that significantly reduces the corporate tax rate could stimulate job growth in the retail sector and the industries supported by retail.

Retailers often serve a central role as stewards of communities. Beyond investing resources in store operations and job creation, brick and mortar retailers: provide billions of dollars annually to tens of thousands of local and national charities; hire American veterans; sponsor local sports and recreation teams; provide tangible goods donations to schools and homeless shelters; support community workforce development and training programs; and often provide shelter during storms and are the first on the ground after disasters strike to provide families with relief and help communities rebuild. Additionally, even the largest retailers rely on small business vendors in communities, such as plumbers and electricians, to keep stores open and operating.

Conclusion

No industry supports and desires comprehensive tax reform more than the retail sector. For retailers, as a driver of the U.S. economy and one of America's largest job creators, operating under the current high effective tax rate is growing untenable. The retail industry is on the front lines with the U.S. consumer and undergoing rapid transformation to compete in the 21st-century marketplace—the U.S. federal tax code should help foster this growth, innovation and investment, not kill it.

RILA and its member companies are eager to work with Members of the Senate Finance Committee in this once in a generation effort to reform the tax code in a comprehensive manner that promotes economic growth and enhances U.S. competitiveness.

SMALL BUSINESS COUNCIL OF AMERICA (SBCA)
4800 Hampden Lane, 6th Floor
Bethesda, MD 20814

The Small Business Council of America (SBCA) appreciates the opportunity to submit this statement.

The SBCA is a national nonprofit organization which has represented the interests of privately held and family-owned businesses exclusively on federal tax, health care and employee benefit matters since 1979. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans.

When embarking on business tax reform, the SBCA urges the Committee to:

- **Not make changes to the small business retirement plan system that could destroy the retirement security of millions of employees and protect the federal tax laws that the system depends on.**

The qualified retirement plan system, has been very successful in providing retirement security for a significant number of Americans. One of the primary things that motivates small business owners to establish, and continue sponsoring, retirement plans are the current tax incentives associated with doing so. Most small business owners view the administrative costs associated of maintaining a plan and the meaningful contributions that they make for non-key employees as the price of being able to save in a qualified retirement plan for themselves. If the tax laws are changed by reducing the amount that a small business owner can save in a qualified retirement plan or the financial appeal of saving in a plan or by making owners concerned about saving too much in a plan, the owners will be much less likely to continue an existing plan or start a new plan. The same will be true if small business owners are given other, more favorable options for saving, such as through the proposed creation of a pre-tax savings account with no withdrawal limitations.

When a small business closes down its retirement plan, the owners are not likely to increase the pay of the non-key employees to account for the loss of the plan contributions, meaning that these employees will be losing a valuable benefit that would provide them with needed funds during their retirement but will not gain any more disposable income.

- **Protect the deductions for retirement plan contributions and health insurance premiums.**

Under the current tax system, when an employer contributes towards an employee's health insurance premiums and/or retirement plan, it is a win-win for the employer and the employee. The employer gets to deduct the contributions and the employee gets the benefit of being able to exclude the contribution from his or her income, in the case of health insurance premiums, or defer taxes on the contribution and allow it to grow tax free, in the case of a retirement contributions. The non-zero-sum nature of this arrangement is a big reason why many employers make these types of contributions. In short, with no detriment to themselves, employers are able to provide a big benefit to employees, many of whom would not be able to afford health insurance or to significantly save for retirement without their employer's contribution.

If the tax laws are modified to either eliminate the benefit employers get from making the contributions (by eliminating or reducing their deductibility) or reduce the benefit that these contributions provide to the employee (by making them taxable to the employee) it would cause employers, particularly small business employers who tend to work on narrower margins, to reduce, or think twice, about making the contribution. Health insurance and retirement savings are critical to the economic stability of this country and the precious equilibrium that allows many individuals to get these benefits, when they otherwise might not, should not be disturbed in an effort to raise revenue for other tax cuts.

Moreover, when it comes to contributions to retirement plans, there is a major distinction between a tax expenditure where the tax is never recaptured by the system and the qualified retirement system where all of the funds in the plan are taxed—just usually outside the budget window because of the long-term nature of retirement savings. It would be fundamentally bad policy to eliminate the retirement plan deduction simply because it helps to raise money within the budget window when it does not result in any long term revenue gain outside the budget window and doing so could greatly harm the retirement security of many Americans.

- **Ensure that the impact of changing the tax rate for pass-through entities does not bring an end to the small business retirement plan system.**

Both the President and the House have proposed reducing the tax rate for pass-through entities by introducing a distinction between "active business income" and "reasonable compensation for services." The SBCA is generally in favor of reducing tax rates for pass-through entities and creating greater parity between pass-through entities and C corporations. However, we have two primary concerns about these proposals.

First, retirement plan contributions need to be deducted from the reasonable compensation for services tranche. Under this proposed change, small business owners would be required to treat a certain portion of the money they receive from the business as reasonable compensation for services which would be taxed at the individual tax rates and the remaining amount would be treated as active business income and taxed at a lower rate—possibly as low as 20%–25%. If contributions that are made to the retirement plan do not count against the amount allocated to the reasonable compensation for services portion before they get to the lower active business income rate, there will be no motivation for small business owners to make contributions to the retirement plan because they will instead be able to take that money and only pay minimal taxes on it and then reinvest it in an area with greater potential for earnings and more favorable tax treatment than a retirement plan. In other words, few small business owners will make contributions into a retirement plan system for themselves and their employees where the deduction is going against a 20%–25% tax rate when it will come out and be taxed at a far higher rate. Economically, this would make no sense and the fuel behind the small business retirement plan system is tax incentives. As discussed further below, few small business owners will sponsor a retirement plan when they will get no financial benefit from saving in it. Rather, the small business retirement system is dependent on small business owners seeing the retirement plan as a way to secure their own future.

Additionally, if Congress is going to move towards establishing a distinction of "active business income" and "reasonable compensation for services" the statute itself needs to clearly delineate how this distinction is made. Simply creating the distinction and leaving it to the IRS to promulgate rules to help businesses determine how to navigate it is a prime recipe for increasing the complexity of the tax system in this area and increasing the burden on pass-through entities. Throughout any tax reform bill, the SBCA strongly encourages Congress to be specific in its statutory language and to avoid delegating the authority to IRS to flesh out all of the rules by regulation in order to avoid efforts towards simplification being marred in the future by complex regulations. As discussed below, small business is still trying to figure out how to deal with the hundreds of pages of regulation that were promulgated under the brief statutory language of IRC § 409A. This type of absurdly complex regulation comes about far more easily when IRS is given little direction in the statutory language.

- **Reject the idea of excluding certain types of pass-through entities from receiving a lower pass-through rate.**

If Congress enacts a new lower rate for pass-through income, this rate should equally applicable to all pass-through entities.

Treasury Secretary Steven Mnuchin has suggested excluding certain types of professional service firms from a new lower pass-through rate. Not only would this proposal be unfair to certain types of businesses, it would directly undermine the goal of simplifying the tax code.

Professional service firms play a critical role in providing essential services and growing the economy. Despite common misconceptions, these businesses make significant investments in equipment and resources to keep their businesses running and there is no reasonable justification for treating them differently.

Moreover, establishing different rates for different types of pass-throughs and determining which pass-throughs are eligible for which rates would add an unnecessary level of complexity to an already complicated tax area and require small businesses to spend even more on accounting and compliance costs than they already do.

The SBCA strongly urges Congress to reject the notion of stratifying the pass-through rates and urges Congress to enact a single lower rate for all pass-through entities.

- **Amend Section 409A to exclude small businesses from its requirements.**

Section 409A was introduced to stop public companies, like Enron, from manipulating deferred compensation to avoid creditors and obtain lower tax rates. Unfortunately, the broad drafting of Section 409A means that small businesses, that were not the culprits of the type of abuses that Section 409A was designed to stem, get caught up in its onerous penalties and excessive compliance costs. The restrictions of Section 409A prevent small businesses from being nimble and entering into compensation arrangements with employees that appropriately reflect the nature of the new or growing business. Worse, many small businesses and their advisors do not even realize that Section 409A applies to them because they've been told it only applies to deferred compensation plans which, due to the tax code, are seldom adopted by small businesses. We think this phantom code section in the small business world could eventually become a huge and unnecessary trap for small business employees.

To eliminate burdensome and unnecessary restraints on business growth, Section 409A should be modified to apply only to publicly traded companies or, at very least, to include an exception for small businesses.

- **Protect the cash method of accounting.**

Over the past number of years there have been multiple proposals to limit the availability of the cash method of accounting for certain pass-through entities and personal service organizations. Proposals like these are a step in the wrong direction and would be harmful to small business.

Particularly for service based companies that often do not receive payment for their services until months or even years after they are performed (and worse often do not receive full or any payment for services rendered), forcing these businesses to use the accrual method of accounting would be very challenging, as well as basically unfair. Without the availability of the cash method, these businesses would need to set aside money to pay the tax liability for services rendered but not paid for yet, if ever.

There is little justification for requiring pass-through entities or personal service organizations to be forced to move to the accrual method of accounting, for example, because their average gross annual receipts are in excess of a certain amount. Moreover, such a change would force dollars that are needed to run the business to be paid instead to internal and external staff and professionals to navigate the much more complex tax situation that the businesses would face under the accrual method.

The SBCA strongly urges Congress to keep the existing rules on cash method of accounting for pass-through entities and professional service organizations. If anything, Congress should increase the annual income threshold for which corporations can use the cash method of accounting above $5 million to ensure that this simpler method is available for all small businesses.

- **Reject proposals to reduce the amount that individuals can save in retirement plans pre-tax or subject existing retirement plan savings to taxes.**

There have recently been proposals to try to move the bulk of the defined contribution retirement plan system towards Roth—*i.e.,* to limit how much can be saved in a defined contribution plan pre-tax or subject existing defined contribution plan balances to taxes now, rather than waiting for them to be taxed at the time of withdrawal.

The SBCA strongly urges the Committee to reject these proposals. According to a 2011 EBRI study, over 60 percent of respondents indicated that the ability to contribute to a retirement plan pre-tax was "very important" to encouraging them to save for retirement (*see* EBRI Notes, Vol. 32, No. 3). The same study found that over 25% of respondents would reduce their retirement plan savings or stop them altogether if they were no longer able to contribute to a retirement plan on a pre-tax basis.

If small business owners aren't able to contribute to a retirement plan pre-tax, they will be less likely to sponsor one and, even if they do, employees will be less likely to save in the plan if they are unable to do so pre-tax. In short, it will decrease the perceived benefit of an employer-sponsored retirement plan for both employer and employees. Given that employees are far more likely to save in an employer-sponsored plan than to set up an IRA for themselves to save in, this is very concerning. America is aging and we need to do everything we can to increase retirement savings. Proposals like these, that would eliminate the motivation to save, could be truly catastrophic.

- **Increase the availability of cafeteria plans for small business employees by allowing small business owners to be eligible to participate in cafeteria plans.**

While employees of large businesses, mid-size employers, non-profits, schools, universities, and the federal government can take advantage of the valuable benefits provided by cafeteria plans, only small business owners are not allowed to participate in a cafeteria plan. As with retirement plans, small business owners will be disinclined to take on the administrative costs and concerns to sponsor a plan that they can't participate in. Cafeteria plans provide a wide array of meaningful benefits for employees and it is unfortunate that the exclusion of small business owners from plan participation has resulted in many small business employees not being offered these benefits.

During the tax reform process, the SBCA urges Congress to resolve this inequity and to allow small business owners to participate in the cafeteria plans that they would be more likely to sponsor.

- **Protect the business interest deduction.**

Both the President and the House have proposed to eliminate the business interest deduction and instead move towards a system of full and immediate expensing. While the SBCA has no problem with the concept of immediate expensing, eliminating the business interest deduction would represent a large change to the tax laws that could strike a significant blow to America's small businesses and make it more difficult for new businesses to get started.

Small businesses rely heavily on traditional debt financing, rather than equity financing. Alternative, or creative, funding options are often not available to small businesses, particularly in their early years. Moreover, debt financing does not require small businesses to give up ownership interests in the way that equity financing does. Eliminating the business interest deduction would mean that the amount paid out in interest would continue to be taxable income to the small business and then also be taxed as income to the lender. In other words, the interest would be taxed twice. Because of this treatment and increased costs, the borrowing options offered by those lenders that typically service small business clients, such as community banks, are likely to be reduced, making it more difficult for small businesses owners to get a traditional loan to get their business started or keep it afloat. The SBCA does not believe there is a valid reason to link the provisions for immediate expensing and the loss of the interest deduction.

As the expression goes, the devil is in the details. Tax reform could help small businesses thrive and continue to provide jobs and meaningful benefits for millions of Americans. However, if not properly and thoughtfully crafted, tax reform could instead prove to be catastrophic to small businesses and their employees, leaving them to bear the burden of tax reform that is targeted at benefiting large businesses. We urge this Committee to be mindful of the role that small business plays in our economy and ensure that small business interests are considered and protected in any efforts towards business tax reform.

SMALL BUSINESS LEGISLATIVE COUNCIL (SBLC)
4800 Hampden Lane, 6th Floor
Bethesda, MD 20814

Please accept the foregoing statement of the Small Business Legislative Council (SBLC) for the record in response to the U.S. Senate Finance Committee's September 19, 2017 hearing on "Business Tax Reform."

The SBLC is a 35-year-old permanent, independent coalition of over 40 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

While the SBLC strongly supports efforts to make the tax system simpler and more manageable, it is critical that tax reform not come at the expense of small businesses and their employees. Already, in the House Blueprint and the President's outline, there have been proposals that are deeply concerning for small business and that could undermine small business' role as a critical driver of growth and job creation in this country. As discussed further below, the SBLC urges the Committee to reject these problematic ideas and use tax reform as a vehicle to help, rather than hinder, small businesses.

Tax Rates for Pass-Through Entities

Greater parity is needed between the tax rates for pass-through entities and C corporations. However, if a new system is created for taxing pass-through entities, the new lower rates should be available to all pass-through entities and the applicable rules should be clearly outlined in the legislation itself and structured to ensure that they do not have the unintended effect of disrupting the small business retirement plan system.

Under the current tax laws, pass-through businesses, which constitute the large majority of business enterprises and employ over half of the employees in the United States,[1] are at a disadvantage when compared to publicly and privately held C corporations. Unlike pass-through entities, regular C corporations separately report their taxable income and pay income tax on that taxable income. Under current law, the top marginal rate for C corporations is 35%, whereas the top marginal rate for income earned through S corporations, partnerships and sole proprietorships is 39.6% (passive investors are also subject to an additional 3.8% net investment tax). **This gap needs to be narrowed or eliminated. If the C corporation rate is going to be reduced through tax reform, the rate for income from pass-through entities must be as well.**

Both the President's outline and the House's Blueprint include proposals to reduce the tax rate for pass-through entities by creating a distinction between "active business income" and "reasonable compensation for services." This type of system would require owners of pass through entities to take compensation for their services, which would be taxed at their personal income tax rate, and then allow them to receive other business income subject to a much lower tax rate. **Provided that the reservations discussed below are adequately addressed, the SBLC strongly supports this concept.**

First and foremost, if a new structure, like the one noted above, is going to be introduced for taxing pass-through entities, it is essential that the rules for its application be clear and outlined in the legislation itself. While the concept of distinguishing between "active business income" and "reasonable compensation for services" sounds relatively simple, the rules for determining what constitutes reasonable compensation for services have the potential to become very complex. Small businesses do not have the same financial or administrative capacity to navigate complicated rules that their larger counterparts do. It is therefore important that the rules be clear and easily understood and applied. To ensure that this is the case, it is important that Congress clearly articulate the framework in the law itself rather than delegating the power to the IRS to do so. Even if the current Administration has given assurances that new tax regulations will not be overly complex, delegating authority to the agencies to add detail to a tax reform law leaves open the possibility (and we would argue makes it likely) that, over time, the law's goal of simplification will be lost amidst increasingly complex regulations.

[1] Drs. Robert Carroll and Gerald Prante, "The Flow-Through Business Sector and Tax Reform," at pg. 5, Appendix B, Ernst and Young (April, 2011).

Another consideration that the SBLC urges the Committee to address in considering a new tax system for pass-through entities, is the implications that a reduced tax rate for business profits could have on the small business retirement plan system. Most small business owners view the administrative costs associated with maintaining a plan and the meaningful contributions that they make for non-key employees as the price of being able to save in a qualified retirement plan for themselves. If the small business owner has the opportunity to take profits out at a rate that is significantly lower than his or her individual tax rate that would apply to retirement funds at the time they are withdrawn, the small business owner is going to take the money out of the business at the reduced rate and invest it elsewhere. In turn, if the small business owner has no financial motivation to save in a retirement plan, the small business is much less likely to create a new plan or continue to offer an existing plan. This would be a significant blow to employees and be counter to the goal of encouraging increased retirement savings. To avoid this problem, if a small business owner is going to be required to take a certain amount from the business as "reasonable compensation for services" before the reduced tax rate will apply, it is important that the contributions towards the retirement plan count towards reasonable compensation for services. Logically, this makes sense as the idea behind the distinction is to ensure that a certain amount of the business' income is being taxed at the business owner's standard individual rate and anything that is saved in a retirement plan will be subject to the individual rate when it is withdrawn. Additionally, it will continue to motivate small business owners to sponsor retirement plans that will allow them, and their employees, to save for the future.

Finally, if a new system is introduced to provide lower rates for certain pass-through income, that lower rate should be available for all pass-through businesses. Attempting to exclude certain types of pass-through businesses from a new lower rate would be unjust and would require the introduction of yet more complex tax rules that small businesses already struggle to navigate.

Business Interest Deduction

Small businesses rely on debt financing not equity to establish themselves and survive. The elimination of the business interest deduction would therefore be severely damaging to small business growth and success.

Both the President's outline and the House Blueprint have proposed to eliminate the business interest deduction in lieu of a move towards allowing full and immediate expensing. While the SBLC supports immediate expensing, eliminating the business interest deduction would result in dramatic loss of financing options for small businesses, making it much more difficult for new businesses to start and existing businesses to thrive.

Small businesses rely heavily on traditional debt financing. Unlike equity financing, debt financing allows small business owners to maintain their ownership of, and control over, their businesses. Moreover, many alternative or creative funding options aren't available to small businesses, particularly in their early years. Eliminating the business interest deduction would result in a double tax on the interest itself. Without the business interest deduction, before being paid as interest, the amount would be taxable to the business, but then would still be taxed as income to the lender. As the result of this treatment, and the increased costs and decreased gains that it will cause, those lenders that traditionally service small business clients, like community banks, are likely to reduce their borrowing options. This will make it more difficult for small businesses to get the debt financing they need and will strike a significant blow to the small business economy on which a huge part of the national economic stability depends.

Last In First Out (LIFO)

The last in first out method of inventory accounting (or LIFO) allows businesses in industries that face rising prices to most closely match the cost of goods sold with the cost of replenishing inventory. In other words, LIFO helps businesses maintain the status quo. Without LIFO, by allowing businesses to avoid being taxed on the portion of their sales attributable to inflation and instead use that money to acquire or produce inventory to replace that which was sold.

The majority of the businesses using the LIFO inventory method are organized in the form of pass-through entities, such as partnerships or S corporations and are therefore taxed at the individual rate. Proposals to fund a reduction in the corporate tax rate by repealing LIFO would leave pass-through entities shouldering most of the burden of a rate reduction while receiving none of the gain.

Moreover, looking to prior proposals to eliminate LIFO, most of the revenue would be raised by a one-time recapture tax. This is a short sited approach that would be devastating for a wide range of businesses. Specifically, not only will the long term revenue stream created by a LIFO repeal be significantly smaller than the one-time recapture, but the one time recapture will also result in an unprecedented retroactive tax on businesses using LIFO. These businesses, have relied on existing tax laws, including the availability of LIFO, to manage their revenue streams, inventories and expenditures. Requiring them to go back and pay taxes on the past benefits that they received from the use of LIFO would wreak havoc on cash flows, capital reserves, expansion opportunities and job creation for American businesses using this method of accounting.

Health Insurance Premium Deduction/Exclusion

The current system which allows employers to deduct health insurance premiums and employees to exclude health insurance premiums from their income, has the very positive effect of encouraging employers to contribute towards health insurance premiums, and should be maintained.

Under the current system, an employer contribution towards an employee's health insurance premium provides a win for both the employer and the employee. The contribution helps the employee get health insurance and can be excluded from the employee's income. In turn, the employer gets to deduct the contribution, so, although it is providing a huge benefit to its employees, it is able to do so at a lower cost.

If the tax laws are changed in a way that would eliminate or reduce the benefit that employers get from contributing towards employee health insurance or reduce the benefit of these contributions to employees by making them taxable, it would cause many small business employers to give second thought to making such contributions. Employer contributions towards health insurance premiums are critical to helping many Americans afford health insurance and any change that would deter employers from making these contributions would be a move in the wrong direction.

The Small Business Retirement Plan System

The qualified retirement plan system has been very successful in providing retirement security for a significant number of Americans. It is important that those provisions that have encouraged plan sponsorship among small businesses and saving by small business employees are not negatively impacted by tax reform.

As noted above, most small business owners are motivated to establish plans, and make contributions for their employees, by a desire to save for their own retirement. If the tax laws are changed to reduce the ability or appeal of saving in a retirement plan, small business owners will be much less likely to continue an existing plan or start a new plan.

Accordingly, so as not to disturb the current successful small business retirement system, the SBLC urges Congress to:

– Reject attempts to decrease the amount that can be saved in a qualified plan. If the amount that small business owners can save in a qualified plan is reduced, small business owners will be motivated to freeze or terminate plans once they themselves have hit that cap. This will mean that less small business employees will be offered a plan.

– Avoid changes that would quickly force saving out of a plan after the owner's death or otherwise do anything to make owners fearful of saving too much in a retirement plan. If small business owners are concerned that at their descendants who inherit their plans will be forced to take the money out over a short period of time and therefore face negative tax consequences, the owner will save less in the plan. This means that retirement savings overall will decrease, as will plan sponsorship.

– Protect the deductibility of employer contributions. As with health insurance, under the current tax system, when an employer contributes to an employee's retirement plan it is a win-win because the employer gets a deduction and the employee grows his or her retirement plan balance. If the deduction for the employer contribution is eliminated, employers will be far less likely to contribute towards an employee's retirement savings.

– Reject proposals to try to limit how much can be saved in a defined contribution plan pre tax or subject existing defined contribution plan balances to taxes now, rather than at the time of their withdrawal (*i.e.,* to move the bulk of the defined contribution retirement plan system towards Roths). Again, if small business owners don't see a tax benefit for themselves to save in the plan, they will be less likely to sponsor a plan. Moreover, if employees are taxed on contributions to a plan, they will be less likely to save, which, given that people are far more likely to save in employer-sponsored retirement plans than in any other vehicle, would reduce retirement savings overall.

Conclusion

As Congress tackles the challenge of tax reform this fall, we urge the Committee to consider how each proposed change could impact small businesses and their employees. Tax reform that pursues a lower corporate rate at the cost of eliminating the critical provisions that small businesses rely on to grow and succeed will be a move in the wrong direction. We look forward to working with this Committee to achieve meaningful tax reform that will benefit businesses of all sizes.

For more information, please contact Paula Calimafde, President and General Counsel, 301–951–9325, calimafd@paleyrothman.com.

LETTERS SUBMITTED BY THE TAX AG COALITION

September 19, 2017

U.S. Senate
Committee on Finance
Dirksen Senate Office Bldg.
Washington, DC 20510–6200

Re: Senate Finance Committee Hearing on Business Tax Reform

Dear Chairman Hatch and Ranking Member Wyden:

The Tax Ag Coalition commends the Senate Finance Committee for your recent hearing on reforming the business tax code, and would like to participate by offering comments on several items of particular interest to agricultural producers and rural small business owners.

While it is not our intent to offer a comprehensive statement on tax reform, the Tax Ag Coalition firmly believes that a fair and equitable tax code must recognize the unique financial challenges of agricultural production. Below is a list of our Coalition priorities and additional information can be found in the enclosed letters.

1. The Coalition supports a full, permanent repeal of the federal estate tax. The benefits of repeal should not be eroded by elimination of or any restrictions to the use of stepped-up basis.
2. The Coalition supports maintaining interest deductions as a legitimate business expense.
3. The Coalition supports maintaining critical provisions in the tax code that allow farmers and ranchers to match income with expenses and manage through low income years, such as cash accounting, like-kind exchanges, and income averaging.
4. The Coalition supports reducing the capital gains tax.
5. The Coalition supports maintaining the Section 199 deduction for domestic production activities.
6. The Coalition supports several tax provisions related to renewable energy and environmental mitigation.

Thank you for your time and attention to this matter.

Sincerely,

Danielle Beck
Director of Government Affairs
National Cattlemen's Beef Association

1275 Pennsylvania Ave., NW, Suite 801
Washington, DC 20004

September 19, 2017

The Honorable Orrin G. Hatch Chairman U.S. Senate Committee on Finance 219 Dirksen Senate Office Building Washington, DC 20510	The Honorable Ron Wyden Ranking Member U.S. Senate Committee on Finance 219 Dirksen Senate Office Building Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of our nation's family farmers and ranchers, the undersigned agricultural producer groups urge your support for maintaining the Section 199 deduction for domestic production activities income as part of any tax reform plan.

The Section 199 deduction was enacted as part of the American Jobs Creation Act of 2004 as a domestic production and jobs creation measure. The deduction applies to proceeds from agricultural or horticultural products that are manufactured, produced, grown, or extracted in the United States, including dairy, grains, fruits, nuts, soybeans, sugar beets, oil and gas refining, and livestock. Farmer-owned cooperatives are able to apply their wages to the calculation of the deduction, and then choose to pass it through to their farmer members or keep it at the cooperative level, making it extremely beneficial to both.

The Section 199 deduction is limited to the lesser of 9 percent of adjusted gross income or domestic production activities income or 50 percent of wages paid to produce such income. Reducing or eliminating the domestic activities deduction would result in a significant increase in taxable income for all farms that currently employ non-family labor. On the other hand, the benefit of the deduction would increase if agricultural producers were able to count non-cash wages paid, such as crop share payments of commodities.

The Section 199 deduction serves as both a domestic production and jobs creation incentive and has provided needed relief for producers in times when prices are depressed. Section 199 benefits are returned to the economy through job creation, increased spending on agricultural production, and increased spending in rural communities.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this important issue.

Respectfully,

Agricultural and Food Transporters Conference	National Pork Producers Council
Agricultural Retailers Association	National Potato Council
American Farm Bureau Federation	National Renderers Association
American Mushroom Institute	National Sorghum Producers
American Sheep Industry Association	Panhandle Peanut Growers Association
American Soybean Association	Southwest Council of Agribusiness
American Sugarbeet Growers Association	South East Dairy Farmers Association
California Association of Winegrape Growers	United Egg Producers
Cobank	United Fresh Produce Association
National Barley Growers Association	U.S. Canola Association
National Cattlemen's Beef Association	U.S. Rice Producers Association
National Corn Growers Association	U.S. Sweet Potato Council
National Cotton Council	USA Rice Federation
National Council of Farmer Cooperatives	Western Growers
National Milk Producers Federation	Western Peanut Growers Association
National Peach Council	Western United Dairymen

September 19, 2017

The Honorable Orrin G. Hatch Chairman U.S. Senate	The Honorable Ron Wyden Ranking Member U.S. Senate

Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

America's farmers and ranchers rely on various tax code provisions to survive the constant financial and economic ups and downs that come with farming and ranching. The undersigned agricultural groups ask for your robust support of these critical provisions that ensure their long-term financial well-being.

Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This provides the flexibility needed to plan for future business investments and in many cases provides guaranteed availability of agricultural inputs. Loss of cash accounting would create a situation where a farmer or rancher would have to pay taxes on income before receiving payment for sold commodities.

Like-kind exchanges help farmers and ranchers operate more efficient businesses by allowing them to defer taxes when they sell land, buildings, equipment, and livestock or purchase replacement property. Without like-kind exchanges some farmers and ranchers would need to incur debt in order to continue their farm or ranch businesses or, worse yet, delay mandatory improvements to maintain the financial viability of their farm or ranch business.

Farm and ranch businesses operate in a constant world of uncertainty with ongoing expenses and a fluctuating income. Income averaging, which permits revenue to be averaged over 3 years, allows farmers and ranchers to level out their tax liability and produces a more dependable and consistent revenue stream that aids financial management.

As Congress moves forward with its tax reform proposals and debate, we urge your support for these important tax provisions. Thank you for your continued efforts to support our nation's farmers and ranchers whose work allows us to enjoy the safest, most abundant and affordable food supply in the world. We look forward to working with you on these important issues.

Sincerely,

Agricultural and Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
California Association of Winegrape Growers
Cobank
National Barley Growers Association
National Cattlemen's Beef Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

September 19, 2017

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219 Dirksen Senate Office Building
Washington, DC 20510

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

Dear Chairman Hatch and Ranking Member Wyden:

The undersigned agricultural organizations urge your support for several tax provisions related to renewable energy and environmental mitigation as part of any broader tax reform plan taken up by Congress.

U.S. farmers and ranchers and the companies that process agricultural products provide food, feed, fiber, and fuel for our nation and the world. Like all businesses, we must continue to innovate, establish new markets, and improve efficiency to remain viable and competitive in today's global market. Whether it is to help reduce regulatory compliance costs or to incentivize renewable energy and conservation benefits, there are a number of tax provisions that have been implemented or proposed for agricultural products and practices.

In recent years, regulators have applied increasing pressure on the agriculture sector to reduce output of nutrients like nitrogen and phosphorus to improve water quality in various watersheds around the country, from the Chesapeake Bay to the Great Lakes region. To help solve this problem, tax-writers in Congress have introduced bipartisan legislation to spur adoption and help cover the upfront capital costs of nutrient recovery technologies, as well as biogas systems that mitigate the environmental impacts of farming by transforming manure into stable fertilizer for crops, bedding for cows, and fuel and electricity for farms and nearby homes.

Tax incentives, such as the biodiesel tax credit, have also existed to support renewable energy and fuel derived from agricultural feedstocks, including animal fats. These renewable energy sources help diversify our fuel supply, establish new markets and add value to farm products, create jobs, and boost economic development, particularly in rural America. U.S. biodiesel producers have unused production capacity that stands ready to be utilized. Putting that capacity to work will encourage further market growth for agricultural products and create thousands of new jobs and billions of dollars in economic activity.

As you move forward with tax proposals, U.S. farmers and ranchers support the inclusion of these tax provisions that help our businesses meet regulatory requirements, provide conservation benefits and incentivize renewable energy production. Thank you for your continued efforts in support of our nation's farmers and ranchers. We look forward to working with you as the process on tax reform continues.

Respectfully,

Agricultural and Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
Cobank
National Barley Growers Association
National Corn Growers Association
National Council of Farmer Cooperatives
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Renderers Association
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

September 19, 2017

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

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

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of the nation's farmers and ranchers, the organizations listed below are writing today regarding one of our priorities for federal tax reform: a reduction in capital gains taxes.

Capital gains taxes have a significant impact on production agriculture and producers' long-term investments in land, breeding livestock and buildings. We believe a reduction of the tax rate on capital gains and assets indexed for inflation would enable producers to better respond to new market opportunities and facilitate the transfer of land to young and beginning farmers.

Taxation for capital gains upon the sale of farm assets creates a number of problems, particularly when an asset sale causes a sharp transitory spike in income that pushes farmers and ranchers into a higher than usual tax bracket. USDA has found that 40 percent of family farms have reported some capital gains or losses, compared to 13.6 percent for an average individual taxpayer.

Another problem is the "lock-in" effect where the higher the capital gains tax rate, the greater disincentive to sell property or alternatively to raise the asking price. in today's agriculture economy, starting a farm or ranch requires a large investment due to the capital-intensive nature of agri-business, with land and buildings typically accounting for 79 percent of farm and ranch assets. Given the barrier created by the capital gains tax, landowners are discouraged to sell, making it even more difficult for new farmers to acquire land and agriculture producers who want to purchase land to expand their business to include a son or daughter. This lose-lose scenario also interferes with capital that would otherwise spur new and more profitable investments.

At a time of heightened financial stress in our agriculture economy, it is more critical now for farmers and ranchers to have the flexibility to change their operations to respond to consumer demand in an increasingly dynamic market. Because of the capital gains taxes imposed when buildings, breeding livestock, farmland and agricultural conservation easements are sold, the higher the tax rate the more difficult it is for producers to cast off unneeded assets to generate revenue, upgrade their operations and adapt to changing markets.

As you continue your work on legislation to reform the tax code, we urge you to carefully consider our recommendations to address these concerns regarding the inadequacies and inefficiencies of current capital gains tax provisions. We acknowledge the extremely complex task of crafting legislation to adopt comprehensive tax reform and appreciate your support of America's farmers and ranchers.

Sincerely,

Agricultural and Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Farmland Trust
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
California Association of Winegrape Growers
Cobank
National Barley Growers Association
National Cattlemen's Beef Association
United Egg Producers
United Fresh Produce Association
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association

National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

September 19, 2017

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

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

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of our nation's family farmers and ranchers, the undersigned groups would like to thank you for your efforts to reform the U.S. tax code in a meaningful way for individuals, corporations, and small businesses alike, including the 3.2 million farmers who generate food, fuel, and fiber for Americans and people around the world. With that in mind, we write today to express our concerns regarding the

House Committee on Ways and Means blueprint proposal to eliminate the deduction for interest payments as a business expense.

Agricultural production is capital-intensive. While financing requirements will vary among the different commodities, the majority of family-owned farming operations are heavily reliant on credit. Even for everyday business, agricultural producers utilize credit in the form of operating and inventory loans. According to the United States Department of Agriculture (USDA), net farm income in 2017 is forecast to decline for the fourth consecutive year by 8.7 percent to $62.3 billion. In a weak farm economy, income is restricted to cover family farmers' living expenses and the repayment of debt. During tough times, producers are often forced to take on substantial annual interest expense. Interest paid on these loans should be deductible because interest is, and has historically been, considered a legitimate business expense.

In addition, family farmers continue to grow their operations in order to remain profitable. Equipment and land acquisition necessary for long-term expansion is only possible through financing. USDA predicts that in 2017, farm real estate debt will reach a historic high of $240.7 billion, a 5.2 percent increase from 2016. Eliminating the interest deduction will place further financial stress on an already debt-burdened industry, and prevent producers from staying profitable in challenging economic times.

Finally, the need for debt financing is particularly important for the next generation of agricultural producers. Less than 2 percent of the U.S. population is directly employed in agriculture. Consistent with a 30-year trend, the average age of principal farm operators is 58, making farmers and ranchers among the oldest workers in the nation. As older producers exit the workforce, financing will be critically important for new and beginning farmers and ranchers looking to establish businesses. Eliminating interest deductions creates a significant barrier for the next generation.

As Congress works to enact comprehensive tax legislation, the positive reforms made should not be undermined by negative, unintended consequences as a result of eliminating the business interest deduction for agricultural entities. It is our hope that future legislative proposals do not ignore this important sector of the nation's economy, and that they will consider the unique utilization and importance of credit management across the entire agriculture sector.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this important issue.

Respectfully,

Agricultural and Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
California Association of Winegrape Growers
Cobank
Farm Credit Council
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Apple Association
U.S. Canola Association
National Barley Growers Association
National Cattlemen's Beef Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

September 19, 2017

The Honorable Orrin G. Hatch
Chairman
U.S. Senate
Committee on Finance

The Honorable Ron Wyden
Ranking Member
U.S. Senate
Committee on Finance

219 Dirksen Senate Office Building
Washington, DC 20510

219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of our nation's family farmers and ranchers, we come together now to ask your support for including permanent repeal of the estate tax in any tax reform legislation moving through Congress this year. In addition, we ask your help to make sure that the benefits of repeal are not eroded by the elimination of or restrictions to the use of the stepped-up basis.

Family farmers and ranchers are not only the caretakers of our nation's rural lands but they are also small businesses. The estate tax is especially damaging to agriculture because we are a land-based, capital-intensive industry with few options for paying estate taxes when they come due. Unfortunately, all too often at the time of death, farming and ranching families are forced to sell off land, farm equipment, parts of the operation or take out loans to pay off tax liabilities and attorney's fees.

As you know, the American Taxpayer Relief Act of 2012 (ATRA) permanently extended the estate tax exemption level to $5 million per person/$10 million per couple indexed for inflation, and maintained stepped up basis. While we are grateful for the relief provided by the ATRA, the current state of our economy, combined with the uncertain nature of our business has left many agricultural producers guessing about their ability to plan for estate tax liabilities and unable to make prudent business decisions. Until the estate tax is fully repealed it will continue to threaten the economic viability of family farms and ranches, as well as the rural communities and businesses that agriculture supports.

In addition to full repeal of the estate tax, we believe it is equally as important for Congress to preserve policies which help keep farm businesses in-tact and families in agriculture. As such, tax reform must maintain stepped-up basis, which limits the amount of property value appreciation that is subject to capital gains taxes if the inherited assets are sold. Because farmland typically is held by one owner for several decades, setting the basis on the value of the farm on the date of the owner's death under stepped-up basis is an important tax provision for surviving family members.

U.S. farmers and ranchers understand and appreciate the role of taxes in maintaining and imp roving our nation; however, the most effective tax code is a fair one. For this reason, we respectfully request that any tax reform legislation considered in Congress will strengthen the business climate for farm and ranch families while ensuring agricultural businesses can be passed to future generations.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this very important issue.

Respectfully,

Agricultural and Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
Livestock Marketing Association
National Association of State Departments of Agriculture
National Barley Growers Association
National Cattlemen's Beef Association
National Cotton Council
National Council of Farmer Cooperatives
U.S. Sweet Potato Council
United Egg Producers
United Fresh Produce Association
USA Rice Federation
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
National Turkey Federation
Panhandle Peanut Growers Association
South East Dairy Farmers Association
Southwest Council of Agribusiness
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association
Western Growers
Western Peanut Growers Association
Western United Dairymen

TAX INNOVATION EQUALITY (TIE) COALITION
Washington, DC 20005
info@tiecoalition.com
202–530–4808 ext. 109

The Tax Innovation Equality (TIE) Coalition[1] is pleased to provide this statement for the record of the Finance Committee's hearing on Business Tax Reform. The TIE Coalition comprises leading U.S. technology and bio-pharma companies that rely on and invest in intellectual property and intangible assets. Such investments help make companies innovative, successful, and globally competitive. The TIE Coalition supports comprehensive tax reform that will modernize the U.S. tax system and help American businesses compete in a global market. The TIE Coalition believes that the U.S. must: (i) implement a competitive territorial tax system; (ii) lower the U.S. corporate tax rate to a globally competitive level; and (iii) not pick winners and losers in the tax code by discriminating against any particular industry or type of income—including income from intangible property (IP).

Unfortunately, some past proposals would tax IP income adversely compared to income from other types of assets, creating an unfair advantage for companies who don't derive their income from IP, and significantly disadvantaging innovative U.S. companies, especially compared to their foreign competition. For example, the Tax Reform Act of 2014 (H.R. 1) as introduced by former House Ways and Means Chairman Camp would seriously disadvantage innovative American companies. Under that proposal, Chairman Camp chose the anti-base erosion option known as "Option C." The problem with "Option C" is that it would significantly disadvantage U.S. IP-based companies who compete globally and it would result in more inversions of U.S. companies and more foreign acquisitions of U.S. companies. The TIE Coalition is *opposed* to "Option C" because it would have a devastating impact on both innovative technology companies and the nation's leading biopharmaceutical companies.

Section 4211 of H.R.1 specifically targets "foreign base company intangible income" for higher taxation by creating a new system in which that income will be *immediately* taxed in the United States at much higher rates (15% or 25%) rather than the 1.25% tax rate for all other foreign income, which is only taxed upon distribution back to the United States. The provision does not provide a definition of an intangible asset. Instead it uses a formula which essentially provides that if a company earns more than a 10% return on its foreign depreciable assets, the income over the 10% threshold will be considered "intangible income" and subject to the higher immediate U.S. tax. Many innovative companies have higher margins and earn more than 10% on their depreciable assets, so they will be disproportionately affected by this adverse provision.

To understand the full scope of "Option C," the TIE Coalition commissioned a study by Matthew Slaughter, the Dean of the Tuck School of Business at Dartmouth. *See,* "Why Tax Reform Should Support Intangible Property in the U.S. Economy," by Matthew J. Slaughter, *http://www.tiecoalition.com/wp-content/uploads/2015/07/IP-White-Paper_January-2015.pdf*. According to the study, "Policymakers should understand the long-standing and increasingly important contributions that IP makes to American jobs and American standards of living—and should understand the value of a tax system that encourages the development of IP by American companies" (Executive Summary).

The study found that "Option C" in the Camp legislation would fundamentally (and adversely) change the measurement and tax treatment of IP income earned by American companies abroad and would disadvantage IP income earned abroad by U.S. companies in three ways. First, it would tax IP income at a higher rate than under current law. Second, it would tax IP income more than other types of business income. Third, it would impose a higher tax burden on the IP income of U.S. companies compared to their foreign competitors. As a result, the study found that "Option C" "would aggravate the nettlesome issue of corporate inversions and would create additional incentives for foreign acquisitions of U.S.-based IP-intensive companies" (Executive Summary).

[1] The TIE Coalition is comprised of leading American companies and trade associations that drive economic growth here at home and globally through innovative technology and biopharmaceutical products. For more information, please visit *www.tiecoalition.com*.

According to the Slaughter study, since globally engaged U.S. companies have long performed the large majority of American's IP discovery and development, it is increasingly important to America's economic success that these companies operate profitably overseas. The Slaughter study finds that the "United States, not abroad, is where U.S. multinationals perform the large majority of their operations. Indeed, this U.S. concentration is especially pronounced for R&D, which reflects America's underlying strengths of skilled workers and legal protections such as IP rights that together are the foundation of America's IP strengths, as discussed earlier" (page 30). The Slaughter study concludes that the overseas operations of these companies complement their U.S. activities and support, not reduce, the inventive efforts, related jobs, and positive economic impact of their U.S. parents on the U.S. economy.

In addition to "Option C," other international tax reform proposals have singled out income from IP for adverse treatment. In 2012, Senator Michael Enzi (D–WY) introduced an international tax reform bill, S. 2091. While the Enzi bill did not propose lowering the corporate tax rate, it did propose a territorial system with a 95% dividends received deduction (DRD) for qualified foreign-source dividends. Unfortunately, while the bill reduced the scope of the current law Subpart F regime in some respects (by eliminating the current foreign base company sales and services income rules under Section 954), it proposed creating a new category of Subpart F income under which all income of a controlled foreign corporation (CFC) would be immediately taxable in the U.S. at the full U.S. rate unless the CFC's effective tax rate (ETR) exceeded half of the maximum U.S. corporate rate. Under Senator Enzi's bill, the ETR in the foreign country would have to be more than 17.5% to qualify for territorial tax treatment with a 95% DRD and avoid immediate taxation at the maximum U.S. tax rate.

However, "qualified business income" (as defined in the bill) would be excluded from this punitive tax treatment and qualify for the 95% DRD. But, "qualified business income" specifically would *not* include "intangible income" as defined in Section 936(h)(3)(B). As such, Senator Enzi's proposal effectively repeals deferral for intangible income earned by CFC's and denies territorial tax treatment with the 95% DRD for intangible income, clearly discriminating against income from intangible assets. In addition to discriminating against income from intangible assets, the Enzi bill would result in significant additional disputes between the IRS and taxpayers regarding whether income is from intangible property as broadly defined in Section 936(h)(3)(B) and if so, how much of that income is attributable to intangible property.

In designing a competitive territorial tax regime, both Congressman Camp and Senator Enzi decided that anti-base erosion provisions needed to be included to protect the U.S. tax base, but they both chose options that discriminate against IP income. The TIE Coalition has offered several anti-base erosion proposals that do *not* discriminate against income from intangibles. Two anti-base erosion measures that we could support are "Option D" and "Option RS." If base erosion is a concern, it is a concern for *all* income, not just income from intangibles.

"Option D" proposes a territorial system with a graduated DRD based upon the effective tax rate paid by the CFC. The general rule of a 95% DRD would apply to foreign source dividends paid from a CFC that has an effective tax rate equal to or greater than 15%. But if the effective tax rate of the CFC is less than 15%, the DRD exemption would be reduced using a simple sliding scale. Under "Option D," if the CFC tax rate is at least 7.5% but less than 15%, the DRD would drop to 85%. If the CFC effective tax rate is less than 7.5%, the DRD would be 75%. If the CFC effective tax rate is less than 7.5% and the CFC is domiciled in a jurisdiction that does not have a tax treaty/possession status/TIEA (or similar relationship) with the United States, the DRD would be 60%. *All* low-tax active foreign income is treated similarly. Income from intangibles is not singled out for especially harsh treatment.

Under "Option RS," low-taxed foreign income of a CFC would be subject to immediate U.S. tax unless it is derived from a substantial local business in the foreign jurisdiction where the income is reported and subject to tax in that jurisdiction. Income would be considered low taxed if the foreign effective tax rate (ETR) is 15% or less. The substantial local business activity test would be met if *all three* of the following tests are met: (1) the income is derived in the active conduct of a trade or business in the foreign country; (2) substantial local activities are conducted in the foreign jurisdiction; and (3) the income is treated as taxable in the foreign country.

In conclusion, the TIE Coalition supports comprehensive tax reform that modernizes the U.S. tax system, allowing American businesses to compete in global markets in a manner that does not discriminate against any particular industry or type of income, including income from intangible property. At a time when many other countries are adopting tax rules designed to attract IP companies to their shores, it would be especially harmful to the U.S. economy to adopt a tax policy that will hurt, not help, American IP companies who compete globally. Now is not the time to drive high paying American jobs overseas.

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