

PERSPECTIVES ON THE NEED FOR TAX REFORM

HEARING
BEFORE THE
SUBCOMMITTEE ON TAX POLICY
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
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**PERSPECTIVES ON THE NEED FOR TAX
REFORM**

WEDNESDAY, MAY 25, 2016

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON TAX POLICY,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:18 p.m., in Room 1100, Longworth House Office Building, the Honorable Charles Boustany [Chairman of the Subcommittee] presiding.
[The advisory announcing the hearing follows:]



WAYS AND MEANS

CHAIRMAN KEVIN BRADY

Chairman Boustany Announces Hearing on Perspectives on the Need for Tax Reform

House Ways and Means Tax Policy Subcommittee Chairman Charles Boustany (R-LA) today announced that the Subcommittee will hold a hearing on Perspectives on the Need for Tax Reform. **The hearing will take place on Wednesday, May 25, 2016, at 2:00 P.M. in Room 1100 of the Longworth House Office Building.**

This hearing will focus on perspectives and considerations that drive the need for tax reform, in particular economic growth, business expansion and job creation, simplicity and burden reduction, and other key motivators. The hearing is part of the Subcommittee's ongoing effort to lay the foundation for legislative action on comprehensive tax reform in 2017.

Oral testimony at the hearing will be from the invited witnesses only. However, any individual or organization may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "Hearings." Select the hearing for which you would like to make a submission, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Wednesday, June 8, 2016**. For questions, or if you encounter technical problems, please call (202) 225-3625.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any materials submitted for the printed record, and any written comments in response to a request for written comments must

conform to the guidelines listed below. Any submission not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

All submissions and supplementary materials must be submitted in a single document via email, provided in Word format and must not exceed a total of 10 pages. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. The name, company, address, telephone, and fax numbers of each witness must be included in the body of the email. Please exclude any personal identifiable information in the attached submission.

Failure to follow the formatting requirements may result in the exclusion of a submission. All submissions for the record are final.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days' notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available at <http://www.waysandmeans.house.gov/>.

Chairman BOUSTANY. The subcommittee will come to order. Welcome to the Committee on Ways and Means, Subcommittee on Tax Policy's hearing on perspectives on the need for tax reform. Today, the subcommittee will hold a hearing to explore the drivers that are motivating the persistent calls for the reform of our broken Tax Code.

At the highest level, that need can be seen in our lackluster economy over the last 8 years in the absence of robust projections for economic growth looking forward. Since the recovery began in 2009, real GDP growth has averaged just 1.8 percent, far below the pre-recession average of 3.5 percent.

Going forward, CBO projects potential growth of just 2 percent. While these shortfalls may seem small, they result in trillions of dollars of lost output and thousands of dollars of lost income for families. Slow growth is a choice, but it is an unacceptable choice, and our bleak economic future demands tax reform.

Tax reform also is an imperative for small and large businesses alike. Our Tax Code simply isn't competitive anymore. We have the highest corporate tax rate in the industrialized world, and a 50-year old international tax approach.

While the U.S. tax rules become more and more outdated, our international partners are moving full steam ahead to become even more competitive. And our inaction is costing us. American businesses are losing ground. American companies are getting acquired by foreign companies. New business startups are lagging. Companies can't expand as rapidly as they should, and capital investment is restrained.

The need for tax reform is further evident in the mind-numbing complexities of the Tax Code and the enormous compliance burdens it imposes on families and businesses in this country. Today's Tax Code consists of about 2.4 million words, and roughly 7.7 million words of regulations and countless more pages of case law, publications, and other guidance.

Is it any wonder that taxpayers are frustrated, especially when they are paying more than \$31 billion annually on software and professional tax preparation services just to figure out their taxes? Americans deserve a simple straightforward tax system that does not waste their valuable time or their money.

Today, we have a very impressive panel of witnesses who will share their perspectives on the need for comprehensive tax reform. With the input the committee receives from today's witnesses and from stakeholders across the board, the committee has a responsibility to respond with a strong tax reform plan that is built for growth. We must harness these motivators for reform in order to advance the work to develop a new Tax Code that is ready for the next President to sign in 2017.

To accomplish that goal, we should also consider ways to motivate tax reform from within Congress, approaches like the Tax Code Termination Act introduced by our colleague, Chairman Goodlatte. In the words of Grover Norquist, president of Americans for Tax Reform, quote, "The idea here is simple. Unite the proponents of many competing replacement tax schemes to support legislation terminating the existing Tax Code by a certain time period to force action," end quote.

Mr. Norquist and Chairman Goodlatte are right about this. We need to look at every avenue to catalyze the process within Congress and get a tax reform bill over the finish line.

Without objection, Mr. Norquist's full statement will be made part of the record.

Chairman BOUSTANY. Before I turn to Mr. Neal for his opening remarks, let me thank our witnesses for taking time today from your busy schedules to be with us. We really appreciate it. We certainly look forward to hearing your testimony.

I am now pleased to yield to the distinguished ranking Member, Mr. Neal, for purposes of an open statement.

Mr. NEAL. Thank you, Dr. Boustany.

Mr. Chairman, I want to thank you for calling this hearing on Perspectives on the Need For Tax Reform. As you stated in your opening comments, the focus of this hearing is on the need for tax reform, but in particular, for economic growth.

None of us can be encouraged by the Federal Reserve's recent suggestion that economic growth is going to be in the vicinity of 2 percent for perhaps the next decade. I agree with the whole notion of business expansion, job creation, and investment, and we all agree, certainly, on the challenges of the current Code. Where we tend to disagree is on the road forward.

One of things that is nice about the panelists we have selected, they have been here many times in the past, and they are all of first class thinking.

I agree with the goals that you have stated, and clearly applaud your commitment to hearing from these individuals in search of the best tax policies. These esteemed witnesses will testify on the need for tax reform, and I do not doubt the ferocity of their testimony. However, we should note that we have heard from them many times in the past on the same issue—issues. And we have had a chance, I think, beginning with at least the piece that Chairman Camp put out to discuss it in more detail.

We almost know what these witnesses are going to say, and I fear that we need to help them help us to break out of the impasse in which we find ourselves. I hold to the position that tax policy cannot be done on the basis of political philosophy and needs to be based upon policy philosophy.

Mr. Chairman, I believe that we must expand our gaze going forward. We also should hear from the American public. And to your point, which I think is entirely correct, we should hear what the presidential aspirants have to say now, not just after that individual takes the oath of office. We need to hear from middle class families. We need to talk about expanding the child credit. We need to talk about how individuals qualify for EITC. The Tax Code's expansive reach touches everyone across this great county. As such, it demands a thorough examination to ensure when we fix it, we are doing our best job.

If I might say, I think we have examined it in great detail time and again. But this will also include listening to the very people that the Code touches. Reforming our Tax Code remains of the utmost importance. I look forward to working with you to ensure that the Code will create jobs, promote economic growth, and once again help to grow the middle class. Thank you, Mr. Chairman.

Mr. BOUSTANY. I thank the gentleman. Today's witness panel includes a number of leading experts on the conditions driving the urgent need to reform our broken Tax Code. We have Douglas Holtz-Eakin, president of the American Action Forum. From 2001 through 2002, Dr. Holtz-Eakin was chief economist on President Bush's Council of Economic Advisers. From 2003 to 2005, he served as director of the Congressional Budget Office.

Next, we have J.D. Foster, vice president of economic policy division and deputy chief economist at the U.S. Chamber of Commerce. Dr. Foster has previously served as economic counsel on the U.S. Department of Treasury, Office of Tax Policy, and as chief economist at the Office of Management and Budget for President Bush.

Scott Hodge is the current president of the Tax Foundation. Prior to joining the Tax Foundation, Mr. Hodge served as director of tax and budget policy at Citizens for a Sound Economy. He also spent 10 years as a fellow at the Heritage Foundation.

And Martin Sullivan is the chief economist and contributing editor for Tax Analysts, daily and weekly publications. Previously, Dr. Sullivan has served as a tax economist at both the U.S. Department of Treasury, and Joint Committee on Taxation.

Gentlemen, we really appreciate you being here. I know this is one of many times that you have appeared before the full committee and subcommittees, and we certainly appreciate you being here today. And we will begin with Dr. Holtz-Eakin. You may begin, sir.

**STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN, PRESIDENT,
AMERICAN ACTION FORUM**

Mr. HOLTZ-EAKIN. Thank you, Chairman Boustany, Ranking Member Neal, and Members of the Committee. I appreciate the opportunity to be here today. You have a written statement. Let me simply emphasize three main points, and I look forward to your questions.

Those points are that tax reform is an opportunity to improve the long-term trend for economic growth, that it is an opportunity to improve our international competitiveness and affect headquarter's decisions, and finally, it is an opportunity to restore lost faith in the Tax Code, and I want to say a little bit about each.

The challenge of economic growth, I think, is the paramount challenge at this time. And to frame it, remember that from the end of World War II to 2007, the U.S. economy grew rapidly enough, 3.2 percent a year on average, that even with population growth, GDP per capita, roughly measured the standard of living, doubled roughly every 35 years. So in one working career, you could see a doubling of the standard of living, and that put American dream within the reach of many Americans, whatever it was to them.

If we have 2 percent trend of economic growth, and you roll in projected population growth, you double the income per capita every 75 years. And I think that just puts the American dream too far over the horizon and that we have to focus on improving growth.

There is great potential to do that. We know from some of the studies cited in my written testimony that the Tax Reform Act of 1986 contributed to better economic growth. That is looking at a real world effort. We know from work of Allen Auerbach and many of his colleagues, that if you were to do an income-style tax reform, you could raise GDP by something like a little under 5 percent. If you did a consumed income tax with a great deal of clarity and discipline, you could raise it by as much as 9 percent.

So there is an opportunity there to contribute to better economic growth, which I believe is the top issue, and you ought to focus on it.

The second is the international competitiveness, with which you are very familiar. The U.S. has a very high statutory rate, highest in the developed world. It also has a very high effective rate. If you look at the computations, it looks like the U.S. is about 28 percent versus 19 or 20 percent for our competitors. And our effective tax rate is higher than 53 out of 58 competitor countries, and it puts us at a tremendous disadvantage. That is compounded by our cling to worldwide base for our international tax system.

Our competitor countries in the OECD have been moving from a worldwide to something more like a territorial, roughly one country per year. We remain the last country clinging to worldwide system, and it has produced a competitive disadvantage. It has produced an incentive to defer funds and keep them locked offshore, and it has produced this terrible situation where when any two companies merge or acquire across borders, when you run the numbers, the headquarters end up outside the United States. And the only way to fix that is to fix the Tax Code and do tax reform.

The Section 385 rulemaking by the Treasury is not a solution. It is making things worse. And indeed, we want to make this a place where people want to locate their investment. Inbound investment is good for the United States. It is not something we should fear. We should have a tax system that incentivizes it.

And then, the last issue is the issue of lost faith in the Tax Code. The U.S. has relied, from its inception, on voluntary compliance

with the Tax Code. But as the complexity has risen, as the administrative costs have risen, and as the tails of people paying zero taxes have sort of proliferated, there is a real sense that I don't know if everyone is playing fair, why should I play fair? Tax reform is a chance to clear that out, and to restore faith in the tax system is something that Americans comply with and that they used to support public policy goals.

I think those three things should be the focus. You have lots of criteria for tax reform. They can be growth, they can be income distribution, they can be complexity, simplicity, administrative and compliance costs. I think you should focus on growth competitiveness and restoring that faith. You can't do everything. You have other policy tools on the spending side to do deal with other issues. I think those are things to focus on, and I hope that this is the last time I testify on the need for tax reform, and I thank you for the chance to do it.

Chairman BOUSTANY. We thank you.

[The prepared statement of Dr. Holtz-Eakin follows:]

Perspectives on the Need for Tax Reform

United States House of Representatives
Subcommittee on Tax Policy,
Committee on Ways and Means

Douglas Holtz-Eakin, President*
American Action Forum

May 25, 2016

*The views expressed here are my own and not those of the American Action Forum. I thank Gordon Gray for his assistance.

Chairman Boustany, Ranking Member Neal, and members of the Committee, thank you for the opportunity to offer my perspective on the need for tax reform. There are many criteria that could be used to guide tax reform; economic efficiency, distributional fairness, administrative ease, compliance cost, simplicity, transparency, and many others. My view, however, is that tax reform should be focused on addressing the major issues of our time, which I would identify as:

- Diminished long-term potential for economic growth;
- International competitiveness and the headquarters location decisions; and
- Lost faith in the U.S. tax system.

Let me discuss these in turn.

Pro-Growth Tax Reform

The Congressional Budget Office (CBO) projects U.S. economic growth to average only 2.1 percent over the next decade, consistent with the experience of the tepid recovery seen since the trough of the Great Recession in 2009. Over the long term, CBO pegs the potential for trend economic growth at 2.0 percent.

This rate of growth is below that needed to improve the standard of living at the pace typically enjoyed in post-war America. From the end of World War II until 2007, the U.S. economy grew at an average rate of 3.2 percent, sufficiently fast to absorb population growth and still double the standard of living (Gross Domestic Product, or GDP, per capita) roughly every 35 years. Put differently, in one person's working career you could anticipate a doubling of the standard of living, thereby providing the capacity for families to pursue their version of the American Dream – buy a house, send a child to college, take a vacation, or whatever their version of the Dream might be.

A 2 percent growth rate translates into doubling GDP per capita roughly every 75 years. The American Dream is disappearing over the horizon. The nation should not settle for 2 percent growth and forgo rising wages for American families, but rather embark on a pro-growth policy agenda that addresses the necessary structural changes to public policy.¹ Tax reform figures prominently in this agenda.

One of the largest distortions income taxes create is decreasing the effective return to work and saving. As people work less and investment in skills, capital, innovations, technology and business models decreases, the economy grows more slowly than it otherwise would. Income taxes have other secondary effects as well, such as incentivizing movement of compensation into tax-free benefits. Much of the academic literature on the effect of

income taxes tends to take a broad approach that focuses on how income taxes affect overall economic growth and output.

The last time the United States undertook fundamental tax reform was the Tax Reform Act of 1986 (TRA86). If history is any guide, a 1986 style reform offers positive impacts on economic growth. This is borne out by retrospective analysis of the TRA86, which found that the 1986 tax reform produced about one percentage point higher growth over a long period. Further studies have shown that the negative relationship with higher marginal rates and taxable income, hours worked, and overall economic growth.²

An important step in the analysis of tax reform and growth was made by the highly respected economists David Altig, Alan Auerbach, Laurence Kotlikoff, Kent A. Smetters, and Jan Walliser; who analyzed multiple tax reforms. They found that GDP could increase by as much as 9 percent higher from tax reform.³ The highest growth rate was associated with a consumed-income tax system that avoided double-taxing the return to saving and investment. A consumed-income approach has been contemplated in past reform efforts, and should be on the table for the Congress. The study also simulated a “clean,” revenue-neutral income tax that would eliminate all deductions, loopholes, *etc.*; and lower the rate to a single low rate. According to their study, this reform raises GDP by 4.9 percent over the long-term – a growth effect that translates (roughly, and admittedly by rounding up) into about 0.5 percent higher trend growth, resulting in faster employment and income growth.

Such an improvement in trend growth would also improve the budget outlook. Deficit savings could be used to pay down the debt, contribute to further rate reduction or some combination of the two. According to the CBO, a 0.1 percentage point annual increase in GDP growth would improve the 10-year deficit by \$327 billion.⁴ Accordingly, a 5-fold improvement would provide \$1.5 trillion in deficit savings.

International Competitiveness and Headquarter Decisions

The U.S. corporate tax code has remained largely unchanged for decades, with the last major rate reduction passed by Congress in 1986.⁵ However, during the interim competitor nations have made significance changes to their business tax systems, by reducing tax rates and moving away from the taxation of worldwide income. Relative to other major economies, the United States has gone from being roughly on par with major trading partners to its current position of imposing the highest statutory rate of corporation income. While less stark than the U.S.’s high statutory rate, the United States also imposes large *effective* rates. According to a study by PricewaterhouseCoopers, “companies headquartered in the United States faced an average effective tax rate of 27.7 percent compared to a rate of 19.5 percent for their foreign-headquartered counterparts. By

country, U.S.-headquartered companies faced a higher worldwide effective tax rate than their counterparts headquartered in 53 of the 58 foreign countries.⁶

The United States fails another competitiveness test in the design of its international tax system. The U.S. corporation income tax applies to the worldwide earnings of U.S. headquartered firms. U.S. companies pay U.S. income taxes on income earned both domestically and abroad, although the U.S. allows a foreign tax credit up to the U.S. tax liability for taxes paid to foreign governments. Active income earned in foreign countries is generally only subject to U.S. income tax once it is repatriated, giving an incentive for companies to reinvest earnings anywhere but in the U.S. This system distorts the international behavior of U.S. firms and essentially traps foreign earnings that might otherwise be repatriated back to the U.S.

While the U.S. has maintained an international tax system that disadvantages U.S. firms competing abroad, many U.S. trading partners have shifted toward territorial systems that exempt entirely, or to a large degree, foreign source income. Of the 34 economies in the Organization for Economic Cooperation and Development (OECD), for example, 28 have adopted such systems, including recent adoption by Japan, the United Kingdom and New Zealand.⁷ According to a 2015 study by the Tax Foundation, the US ranks last in corporate income tax competitiveness compared to OECD countries.⁸

One manifestation of the competitive disadvantage of the U.S. corporation income tax is decisions on the location of headquarters. The issue of so-called “inversions” remains at the forefront of tax policy and politics. Originally, tax inversions involved a single company flipping the roles of U.S. headquarters and foreign subsidiary — i.e. “inverting.” Tax changes in the early 2000s largely ended this practice. Next, whenever a U.S. firm sought to acquire or merge with a foreign firm, the tax advantages of being subjected to a lower rate and a territorial base made it inevitable that the combined firm would be headquartered outside the U.S. In these cases, inversions took place in the context of these otherwise strategic and valued business opportunities. Most recently, foreign firms have recognized that freeing U.S. companies of their tax disadvantage allows foreign acquirers to use the same capital, technologies and workers more effectively. Inversions are now occurring because foreign firms are acquiring U.S. firms.

A recent macroeconomic analysis of former Chairman Camp’s tax reform proposal is instructive on the incentives inherent in the current tax code for capital flight. John Diamond and George Zodrow examined how reform similar to that proposed by former Chairman Camp would affect capital flows compared to current law.⁹ In the long-run, the authors estimated that a reform that lowered corporate rates and moved to an internationally competitive divided-exemption system would *increase* U.S. holdings of firm-specific capital by 23.5 percent, while the net change in domestic ordinary capital would be

a 5 percent increase. It is important to note that these are relative measurements – they are relative to current law. If the recent spate of announcements of inversions is any indication, current law is inducing capital flight. Accordingly, the 23.5 percent and 5 percent *increases* in firm-specific and ordinary stock, respectively, may be interpreted in part as the effect of precluding future tax inversions.

Placing a value of this potential equity flight is uncertain, but based on these estimates, roughly 15 percent, or \$876 billion in U.S. based capital is at risk of moving overseas. Reforming the international corporate code would preclude this capital flight and prevent associated job losses.¹⁰

Finally, it is an important reminder, particularly in the current political climate, that the burden of the corporate tax is borne by everyone. Corporations are not walled off from the broader economy, and neither are the taxes imposed on corporate income. Taxes on corporations fall on stockholders, employees, and consumers alike. The incidence of the corporate tax continues to be debated, but it is clear that the burden on labor must be acknowledged. Indeed, one recent study found that labor bears as much as 70 percent of the corporation income tax rate.¹¹ Other studies have found similar implications, with a study by economists at the American Enterprise Institute concluding that for every one percent increase in corporate tax rates, wages decrease by one percent.¹² These wage effects should be considered in thinking about the impact of tax reform.

Restoring Faith in the Tax Code

The U.S. code is complex, confusing, costly to operate and comply with, and leaves taxpayers distrustful that everyone is paying the share Congress intended. In 2013, over 147 million individual tax returns were filed, covering over \$9.1 trillion in income.¹³ These returns also include millions of businesses that do not file as C-Corporations. As of 2012, there were 31.1 million non-farm businesses filing tax returns: 23.6 million sole-proprietors, 4.2 million S-corporations, and 3.4 million partnerships (including LLCs). The IRS also recognized 1.6 million C-corporations.¹⁴ The tax system is often the most direct interface between individuals and businesses and the federal government.

Unfortunately, that experience is often deeply unsatisfactory. The IRS has 1,050 forms with which taxpayers must contend and requires an average of 11.1 hours per paperwork submission. The overall burden on taxpayers is 8.9 billion hours in paperwork burden imposed by the tax collection system on taxpayers.¹⁵

As many Americans have experienced, the tax filing process is extremely time intensive and often requires the help of outside expertise. Tax compliance is so onerous for individual

taxpayers, 94 percent of individual taxpayers used a preparer or tax software to prepare their returns. The Taxpayer Advocate Service (TAS), the watchdog office within the IRS, has stated in the past that complexity is the single most serious problem with the tax code. This complexity is also straining the administrative capacity of the IRS. As the amount of work required to complete tax filing increases, the ability of the agency to respond to inquiries declines. According to the TAS, the IRS received over 100 million calls in 2015 and answered only 62 percent of calls received, as compared to 87 percent in 2004. The IRS failed to respond in a timely manner to 50 percent of taxpayer letters received in 2012, compared to 12 percent in 2004.¹⁶

The burden on individuals filing their taxes also translates to a large scale negative economic impact. Fichtner and Feldman assessed the costs that the U.S. tax code extracts taxpayers through complexity and inefficiency. The study finds that, in addition to time and money expended in compliance, foregone economic growth, and lobbying expenditures amount to hidden costs are estimated to range from \$215 billion to \$987 billion.¹⁷

Thus individuals are confronted with a burdensome and costly tax code that, despite its progressivity is perceived as being skewed to benefit the wealthy or well connected. News reports of firms not paying corporate taxes or politicians bemoaning those not paying their "fair share" further this perception. Though these reports are often highly misleading, their conclusions are widely accepted among the American public.¹⁸ Sound tax reform can reconcile these perceptions of being unfair with economic efficiency. Many of the tax expenditures in the tax code fail the economic cost-benefit test and also broadly benefit higher income individuals and businesses.¹⁹ Efficient tax reform can broaden the tax base, lower overall rates, and reduce or eliminate tax provisions that feed the perceived unfairness in the tax system.

Conclusion

The U.S. tax system hasn't been overhauled in 30 years. Since the 1986 tax reform effort, individual and corporate tax rates have crept up, while the number of tax expenditures has expanded. The tax system is ripe for an overhaul, an effort that could simultaneously enhance the nation's growth outlook, staunch the flow of corporate inversions, and improve public perceptions of fairness. Thank you for the opportunity to address the need for tax reform as a pressing and overdue policy imperative. I look forward to your questions.

Notes

¹ <http://waysandmeans.house.gov/wp-content/uploads/2016/02/20160202FC-Holtz-Eakin-Testimony-CLEAN.pdf>

² See: Feldstein, Martin, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act." *Journal of Political Economy*, June 1995, (103:3), pp 551-72; Carroll, Robert, Douglas Holtz-Eakin, Mark Rider and Harvey S. Rosen, "Income taxes and entrepreneurs' use of labor." *Journal of Labor Economics* 18(2) (2000):324-351; Prescott, Edward C., "Why do Americans Work So Much More Than Europeans." Federal Reserve Bank of Minneapolis July 2004; Skinner, Jonathan, and Eric Engen. "Taxation and Economic Growth." *National Tax Journal* 49.4 (1996): 617-42; Romer, Christina D., and David H. Romer, "The

Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks." National Bureau of Economic Research NBER Working Paper No. 13264 July 2007 Web.<http://www.nber.org/papers/w13264>

³ Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters and Jan Walliser, "Simulating Fundamental Tax Reform in the United States." *American Economic Review*, Vol. 91, No. 3 (2001), pp. 574-595

⁴ <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016Outlook.pdf>

⁵ <http://americanactionforum.org/research/economic-and-budgetary-consequences-of-pro-growth-tax-modernization>

⁶ PricewaterhouseCoopers (2011). *Global Effective Tax Rates*. Washington, DC

⁷ http://businessroundtable.org/uploads/studies-reports/downloads/Taxation_of_American_Companies.pdf

⁸ http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_ITCI_2015.pdf

⁹ http://businessroundtable.org/sites/default/files/reports/Diamond-Zodrow%20Analysis%20for%20Business%20Roundtable_Final%20for%20Release.pdf

¹⁰ <http://www.americanactionforum.org/research/economic-risks-proposed-anti-inversion-policy-update/>

¹¹ William C. Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office Working Paper No. 2006-09, at <http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf> (April 3, 2009).

¹² Kevin A. Hassett and Aparna Mathur, "Taxes and Wages," American Enterprise Institute Working Paper No. 128, June 2006.

¹³ <https://www.irs.gov/pub/irs-soi/soi-a-inpd-id1505.pdf>

¹⁴ <https://www.jct.gov/publications.html?func=startdown&id=4903>

¹⁵ <http://www.americanactionforum.org/insight/tax-day-2016-regulatory-side/>

¹⁶ <http://www.americanactionforum.org/insight/tax-day-2016-regulatory-side/>

¹⁷ Fichtner, Jason J. and Jacob M. Feldman, "The Hidden Costs Of Tax Compliance." Mercatus Center 2015 Web. <http://mercatus.org/sites/default/files/Fichtner-Hidden-Cost-ch1-web.pdf>

¹⁸ See for example, http://www.americanactionforum.org/wp-content/uploads/sites/default/files/Future_of_Taxes_and_Small_Biz_final%5b1%5d.pdf and

<http://www.americanactionforum.org/insight/oxfam-report-factual-inaccuracies-musings/>

¹⁹ <http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768-DistributionTaxExpenditures.pdf>

Chairman BOUSTANY. Dr. Foster, you may proceed.

STATEMENT OF DR. J.D. FOSTER, VICE PRESIDENT, ECONOMIC POLICY DIVISION AND DEPUTY CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Mr. FOSTER. Thank you, Mr. Chairman, Ranking Member Neal, Members of the Committee. My name is J.D. Foster. I am the Vice President in Economic Policy and Deputy Chief Economist at the U.S. Chamber of Commerce.

I would venture to say that in the decade since the last major tax reform was enacted, the Ways and Means Committee has held scores of hearings and had thousands of hours of testimony and debate on the need for comprehensive tax reform. In retrospect, it is a daunting task to think that one could add to that mountain of evidence. I am sure my co-panelists will equip themselves well in trying to do so.

Little has really changed over the course of these many years relevant to comprehensive tax reform, little except the urgency for tax reform has itself grown, and the price of inaction has grown higher, as the relative economic strength of other nations and their businesses has grown rapidly.

A related difference from the past is the apparent dimming of America's economic future to which you alluded. The weakest economic recovery in the modern era continues but just barely, and it is now showing distinct signs of slowing further. In the most recent quarters, the economy has slipped from a pedestrian 2 percent growth to 1.4 percent, and the most recently, to 0.5 percent. This is not a good sign.

This comprehensive tax reform moves forward in fits and starts. It should always move forward with improving economic growth as the primary focus, not the simplification or improving transparency, or these other issues commonly raised are unimportant, they are important. But as the saying goes, they don't feed the bulldog. The only thing that really drives tax reform making the whole effort worthwhile is economic growth.

The concept of economic growth is something of an abstraction. Gross domestic product is something we commonly cite, and the reality is few people really know what it means, and in any event, it is an imperfect measure of the economy. More critically, businesses, American businesses, workers, and families don't live in a world of abstractions. They deal with real issues day to day.

In communicating the need for comprehensive tax reform then, the choices made in developing legislation something more real is needed, something which regular people can relate to.

What does "grow the economy" really mean in simple English? Well, in simple English, it means more small businesses, more medium-sized businesses, more big businesses all doing more business. It is as simple as that. The U.S. economy doesn't grow until businesses are growing in number and size. Washington policies would result in more jobs, higher wages, and more opportunities if the frame of reference involved a stronger focus on the business environment.

We would do better if Congress stopped believing its wisdom superior to that of individuals and businesses participating in markets channeling those actions.

Comprehensive tax reform can play a very constructive role. What do businesses do to grow the economy? Very simply, they make more stuff people want. They hire more workers to make more stuff. They pay their workers better because they can and because they must to have a quality and quantity of workers needed to make more stuff. Businesses invest in new technology so they can have—do a better job of making stuff and making better stuff. They invest in new machines and facilities so they can make more stuff in the future, and to incorporate the new make-better-stuff technology in their production today. Businesses want a return for their investors, so the investors are willing to continue to invest, so businesses can make more stuff. You will notice a trend here. And yes, along the way, businesses collect a lot of tax.

The businesses play a central role in the symphony of commerce. They raise capital, pay owners, buy stuff from other businesses, hire and pay workers, and the income paid out is the income that is then used by consumers to buy the stuff businesses make. It is a system where everybody contributes something, and everybody who contributes, gets something. It is a system of coordination guided by markets and prices and a system where competition drives everyone to do better in some way or another.

Why, then, if a growing economy is all about growing businesses, is the economy not growing as it should? Have American businesses lost their edge? Has the American entrepreneurial spirit dimmed? No, it has not. The economy isn't growing as it should because for businesses to grow normally, they need government policies, including tax policy that are at least benign for the economic environment. Businesses generally don't need government to be their partner or to help. They mostly just need government to get the basics right and then get out of the way.

And this is where comprehensive tax reform comes in with an unwavering focus on creating a better business environment. That means an unwavering focus on improving economic growth. Now, economists have a lot of fancy theories and ideas about how economies grow and don't grow. At some point in time, it is important to take a step back from all the fancy theories to consider basic realities. The basic reality is that a growing economy results from businesses doing well what businesses do naturally, and that depends on the government creating an environment where businesses can flourish.

Comprehensive tax reform focused squarely on improving economic performance would go a long way toward creating that environment. Thank you, Mr. Chairman.

Chairman BOUSTANY. Thank you, Dr. Foster.

[The prepared statement of Dr. Foster follows:]



Statement of the U.S. Chamber of Commerce

ON: The Need for Comprehensive Tax Reform

**TO: The Subcommittee on Tax Policy
House Committee on Ways and Means
United States House of Representatives**

DATE: May 25, 2016

1615 H Street NW | Washington, DC | 20062

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Testimony of Dr. J.D. Foster

**Vice President, Economic Policy, and Deputy Chief Economist
United States Chamber of Commerce**

On the Need for Comprehensive Tax Reform

before

**The Subcommittee on Tax Policy
House Committee on Ways and Means
United States House of Representatives**

May 25, 2016

Thank you, Mr. Chairman, Ranking Member Neal, Members of the Committee. My name is J.D. Foster, I am the Vice President, Economic Policy, and Deputy Chief Economist at the United States Chamber of Commerce. The Chamber is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions. I appreciate the opportunity to testify before the subcommittee today on behalf of the businesses the Chamber represents.

I would venture that in the decades since the last major tax reform was enacted, the Ways and Means Committee has held scores of hearings and heard thousands of hours of testimony and debate on the need for comprehensive tax reform. In retrospect, it is a daunting task imagining one can add materially to that body of evidence.

Little has really changed over the course of these many years relevant to this topic, except that the urgency for comprehensive tax reform has grown and the price of inaction has grown higher as the relative economic strength of other nations and their businesses has grown rapidly.

A related difference from the past is the apparent dimming of America's economic future. The weakest economic recovery in the modern era continues, but just barely, as it is now showing distinct signs of slowing further. In the most recent quarters the growth rate has fallen from a very pedestrian 2.0 percent, to 1.4 percent, and apparently slowed even further, to 0.5 percent, in the first quarter of 2016.

Beyond the immediate concerns of an economy slowing from slow, concerns mount as to how the U.S. economy has slid into an apparent semi-permanent cycle of

unusually slow growth. Many arguments are made in support of this hypothesis, some of them demographic in nature, but demographics can only explain a small, and well-anticipated part of the observed phenomenon. The substantial decline in labor productivity growth demands other explanations, explanations readily found in ill-considered anti-growth economic policies out of Washington. While I would put the still-building deluge of harmful regulatory policies at the top of the causal list, there's no doubt our archaic, anti-growth tax code also plays a major role.

As comprehensive tax reform moves forward in fits and starts, it should always move forward with the primary focus of improving economic growth. Not that simplification or improving transparency or other issues commonly raised are unimportant, but, as the saying goes, these issues "don't feed the bulldog". Growth is the issue demanding attention.

One problem immediately arising for many, however, is that "economic growth" is something of an abstraction. Gross Domestic Product is commonly cited, but few really know what it means, and it is in any event an imperfect measure of "the economy". More critically, American businesses, workers, and families don't live in a world of abstractions. They deal with real issues day-to-day. In communicating the need for comprehensive tax reform, and the choices made in developing legislation, something more "real" is needed, something to which regular people can relate.

What does "grow the economy" really mean in simple English? It means more small businesses, more medium-sized businesses, more big businesses, all doing more business. The U.S. economy doesn't grow until businesses are growing in number and in size.

Washington policies would result in more jobs, higher wages, and more opportunities if the frame of reference involved fewer gimmicks and fewer abstractions like competitiveness and productivity and "fairness", and focused instead on the fundamentals, like, what does it take to create a good environment for business.

What do businesses do to grow the economy? They make more stuff people want. They hire more workers to make more stuff. They pay their workers better because they can and because they must to have the quantity and quality of workers needed to make more stuff.

Businesses invest in new technologies so they can do a better job of making stuff and to make better stuff. They invest in new machines and facilities so they can make more stuff in the future, and to incorporate the new make-stuff-better technology in their

production today. Businesses earn a return for their investors so the investors are willing to continue to invest so businesses can make more stuff. And, yes, they collect tax, a lot of tax.

Businesses play a central role in the symphony of commerce. They raise capital and pay owners, buy stuff from other businesses, hire and pay workers, and then the income paid out is then the income used by consumers to buy the stuff businesses make. It is a system where everybody contributes something and everybody who contributes something gets something. It is a system of coordination guided by markets and prices, and a system of competition driving everyone to do better in one way or another.

Why, then, if a growing economy is all about growing businesses, is the economy not growing as it should? Have American businesses lost their edge? Has the American entrepreneurial spirit dimmed? Hardly.

The economy isn't growing as it should because for businesses to grow normally they need government policies that are at least benign for the economic environment. Businesses generally don't need government to be their "partner", or to "help", they mostly just need government to get the basics right and then get out of the way.

This is where comprehensive tax reform comes in, with an unwavering focus on creating a better business environment, read: an unwavering focus on improving economic growth. The U.S. Chamber of Commerce's Board approved principles provide a sound foundation:

- 1) Tax reform legislation should reduce corporate tax rates and also consider the impact of a corporate rate reduction on pass-through entities.
- 2) Tax reform legislation should eliminate the bias against capital investment either through expensing or through a capital cost recovery system providing the present value equivalent of expensing with due regard to the impact the system may have on cash flow.
- 3) The current worldwide system of international taxation should be replaced with a territorial system.
- 4) Changes should be permanent to ensure certainty.
- 5) Fundamental tax reform should take place in the near-term.

- 6) Congress should enact simple, predictable, and easy to understand tax rules to improve compliance and reduce the cost of tax administration.
- 7) Tax reform should ensure industry-specific neutrality and avoid special tax benefits or penalties targeted to one industry versus another. Tax reform should allow the marketplace, not the tax system, to allocate capital and resources.
- 8) Comprehensive tax reform should include realistic transition rules to provide adequate time for implementation and to help minimize hardships businesses may encounter in transitioning to the new tax system.

This Committee, and its counterpart in the United States Senate, have worked hard in recent years to prepare for comprehensive tax reform. Former Chairman Dave Camp went so far as to put forward a draft proposal. Current Chairman Kevin Brady has made plain the seriousness of his intentions, especially with regard to international tax issues, and Senate Finance Committee Chairman Hatch has his staff working on the knotty problem of finding the best way to eliminate the double taxation of corporate income, known as integration.

Unfortunately, the work of the Congress has not been matched by the current Administration whose role is best marked by its absence and most recently by stunning regulatory overreach. As the clock runs out on this Administration, one can only hope, for the sake of America's workers, families, and, yes, the businesses that grow the economy, that the next Administration is more open and interested, not just in talking about a stronger economy, but working toward a tax system that will encourage a stronger economy.

Economists have a lot of fancy theories and ideas about how the economy grows, or doesn't grow. But sometimes it's important to step back from fancy theories to consider basic realities. The basic reality is that a growing economy results from businesses doing well what businesses do naturally, and that depends on government creating an environment where businesses can flourish. Comprehensive tax reform focused squarely on improving economic performance would go a long way toward creating such an environment.

Chairman BOUSTANY. Dr. Hodge, you may proceed.

STATEMENT OF SCOTT HODGE, PRESIDENT, TAX FOUNDATION

Mr. HODGE. Thank you very much, Mr. Chairman, Mr. Neal, Members of the Committee. I want to focus my testimony today on the economic cost of tax complexity, which is a new topic for me today for this committee. I thought we would change it up a little bit this time around.

In addition to robbing us of about 8.9 billion hours, and more than \$400 billion in lost productivity, tax complexity punishes success and hard work, which robs the economy of its ability to create jobs and better living standards. Over the past few months, Tax Foundation economists have been measuring the cost of complex tax provisions using our taxes and growth macroeconomic model. And in 2 weeks, we will publish nearly 100 of these case studies in a new book called, "Options for Reforming America's Tax Code," and I hope that these case studies provide you some do's and don'ts as you think about how to reform the tax system.

And we find that much of the tax complexity in, say, our individual Tax Code results from our attempts to make the system more progressive, either overtly through graduated tax brackets, or subtly through backdoor phaseouts and clawbacks. And high marginal tax rates matter to work incentives and dampen economic growth. Economists refer to these high marginal rates as success taxes.

For example, we can make our current seven-bracket tax rate system simpler, more pro growth and still progressive, simply by reducing the number of brackets to 3, 10, 15 and 35 percent. And compared to that kind of an economic system, our model finds that the current Tax Code effectively reduces the long run level of GDP by 1.4 percent, lowers after tax incomes by an average of 3 percent, and costs the economy about 1 million jobs.

You know, our policy's aim at helping the working poor can also have unintended consequences. The complex structure of the EITC has the ironic effect of encouraging more work as the subsidy phases in, but then discouraging work effort as the subsidy phases out as—because it penalizes workers for every dollar that they earn above the poverty line.

However, we can reduce these tax penalties with a slower phase-out rate for the EITC. And compared to that kind of a, what I would call fairy EITC, our model finds that the current rules lower after tax incomes by more than 1 percent and costs the economy 164,000 jobs.

I think we all want to simplify the number of itemized deductions and loopholes in the Tax Code, but we ought to use those savings to lower tax rates across the board. We found that if you were to eliminate most itemized deductions, except for the charitable deduction, home mortgage interest deduction, and use those revenues to lower tax rates across the board by 10 percent, it would increase GDP by about 0.6 percent and create 577,000 jobs.

On the business side, as we have already heard, everyone knows that the U.S. has the highest corporate tax rate in the industrialized world. Only Chad and the United Arab Emirates impose a higher corporate tax rate than we do, and we have an obsolete ter-

ritorial system. So moving to a lower rate and—or we have an absolute worldwide, and moving to a territorial system would greatly simplify the tax system and make the U.S. more competitive.

But just as importantly, we should replace our immensely complicated depreciation and cost recovery system with a much simpler system of full expensing of capital investments. Dollar for dollar, full expensing is one of the most pro-growth tax simplifications that Congress could enact.

By our estimates, moving to a full expensing would boost GDP by over 5 percent, boost wages by over 4 percent, and increase the number of jobs by a million.

Over the past year, Tax Foundation economists have gained special insights into what kind of tax policies boost economic growth, wages, jobs, and investment, and we have learned what not to do as well. We have scored the tax plans of every presidential candidate, as well as numerous tax plans proposed by Members of Congress, including some on this committee.

And during this experience, we modeled every conceivable tax reform plan you can think of, flat tax, fair tax, Bradford X tax, value-added tax, and numerous plans that mix and match many of those features.

And to one degree or another, these plans, the plans that produce the most economic growth tend to incorporate some of the lessons we have outlined here today. They simplify the Tax Code, they reduce marginal tax rates, they reduce taxes on capital, they reduce or eliminate the double taxation of savings and investment, and they move toward a neutral consumption tax base.

So to wrap up, I hope that Members of this committee, as well as your fellow lawmakers, take some of these lessons at heart and move us down the road to fundamental tax reform as soon as possible. Thanks for your time. I welcome any questions you may have.

Chairman BOUSTANY. Thank you, Dr. Hodge.
[The prepared statement of Dr. Hodge follows:]



Written Testimony
Of
Scott A. Hodge
President
Tax Foundation
Before the Ways and Means Subcommittee on Tax Policy

“Perspectives on the Need for Tax Reform”

Thank you Chairman Boustany and Ranking Member Neal for the opportunity to talk with you today about the need for tax reform.

There are many reasons to reform our tax code, but the cost of tax complexity to our nation's economy should be near the top of that list.

Over the last century, the federal tax code has expanded dramatically in size and scope. In 1955, the Internal Revenue Code stood at 409,000 words in length. Since then, it has grown to a total of 2.4 million words: almost six times as long as it was in 1955 and almost twice as long as in 1985.

However, the tax statutes passed by Congress are only the tip of the iceberg when it comes to tax complexity. There are roughly 7.7 million words of tax regulations, promulgated by the IRS over the last century, which clarify how the U.S. tax statutes work in practice. On top of that, there are almost 60,000 pages of tax-related case law, which are indispensable for accountants and tax lawyers trying to figure out how much their clients actually owe.

Tax complexity creates real costs for American households and businesses, starting with just the time it takes us to comply with the tax code. According to the latest estimates on Reginfo.gov, Americans spend over 8.9 billion hours complying with IRS tax filing requirements, equal to nearly 4.3 million full-time workers doing nothing but tax return paperwork. To put that in perspective, 4.3 million is greater than the populations of 24 U.S. states.

Put in dollar terms, those 8.9 billion hours add up to more than \$400 billion each year¹ in lost productivity, or greater than the gross state product of 36 states.

Tax complexity, and the fear of making mistakes, motivates about 62 percent of all taxpayers to use tax return preparers, but the percentage climbs to about 73 percent for the poorest Americans claiming the EITC.²

But tax complexity creates other costs besides our lost time. Many of the most

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. We are a 501(c)(3) non-profit organization.

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¹ Authors calculations: See the appendix for details.

² National Taxpayer Advocate, Report to Congress: Fiscal 2010 Objectives, June 30, 2009, p. xxii, http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf

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complex features of the tax code distort individual and business behavior in numerous ways that leads to long-run economic harm. And we can measure that economic harm using the Tax Foundation's Taxes and Growth (TAG) Macroeconomic Tax Model.

To illustrate the tax code's harmful economic effects, I've selected a number of examples from the Tax Foundation's forthcoming *Options for Reforming America's Tax Code*. The *Options* book will contain nearly 100 specific policy changes to the individual and corporate tax code that have been scored with the TAG model. Each "Option" will include an estimate of the policy's economic effects (such as on GDP, wages, and jobs), revenue effects (measured conventionally and dynamically), and the distributional effects (also measured conventionally and dynamically).

The Individual Income Tax

I'll begin with the individual income tax code, which is filled with dozens of credits, deductions, limitations, and other special provisions that make life more complex for American taxpayers.

Much of the complexity in our individual tax code results from our attempts to make the system progressive, ensuring that as taxpayers' income rise, so too does their tax liability. Over the decades, lawmakers have attempted numerous ways of making the tax system progressive, either overtly with graduated tax brackets, or more subtly through phaseouts and claw-backs. As we will see, there is a real tradeoff between progressivity and economic growth.

Graduated Tax Rates

Before the 1986 Tax Reform Act, a married couple was faced with 15 separate tax brackets as high as 50 percent. During the 1970s, those couples faced as many as 26 brackets as high as 70 percent. A taxpayer claiming Head of Household status faced 34 brackets as high as 70 percent.

Today, the tax code has seven brackets, with rates of 10, 15, 25, 28, 33, 35, and 39.6 percent. In many ways, multiple graduated tax rates make no sense because progressivity can be accomplished with as few as two rates—zero and, say, 10 percent, for example. Obviously, those paying at the 10 percent rate would pay a greater share of their income in taxes than those paying at the zero rate.

Adding rates and brackets beyond the first one simply becomes punitive because we know that marginal tax rates matter. When the "tax price" of earning the next dollar of income gets too high, people will stop working to earn that extra dollar or begin to engage in unproductive tax avoidance measures. Economists have referred to these high progressive tax rates as "success taxes."³

To illustrate the economic harm caused by the current progressive tax bracket structure, we used the TAG model to simulate the economic effects of an income tax with three brackets of 10, 25, and 35 percent. When we compare the economic performance of the new bracket structure to the baseline economic levels, the model estimates that the current bracket

³ Gentry, William H. & R. Glenn Hubbard (2004). *Success Taxes, Entrepreneurial Entry and Innovation*, NBER Working Paper No. w10551.

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structure is effectively reducing GDP by 1.4 percent, incomes by 3 percent, and eliminating the equivalent of more than 1.1 million full-time jobs.

PEP and Pease

Recognizing that statutory marginal tax rates matter, lawmakers have often turned instead to backdoor efforts to raise additional taxes from higher-income households. Two particular tax code provisions stand out as overly complex attempts to increase taxes on the wealthy: the Pease limitation on itemized deductions and the personal exemption phaseout (PEP).

The Pease limitation on itemized deductions reduces the value of a taxpayer's itemized deductions by three cents for every additional dollar of income earned. While the Pease limitation is framed as a limit on itemized deductions, it actually resembles a marginal surtax on high-income taxpayers, with a top rate of 1.188 percent. The TAG model indicates that maintaining the Pease limitation reduces long-run GDP by 0.3 percent and costs the equivalent of 187,000 full-time jobs.

Similarly, PEP reduces the value of the personal exemption for upper-middle income households. Because each additional dollar that these households earn leads to a smaller personal exemption, PEP is essentially equivalent to a marginal surtax of at least 1 percent. The TAG model simulation indicates that PEP reduces long-run GDP by 0.1 percent, and costs the economy the equivalent of 87,000 full-time jobs.

The Earned Income Tax Credit

At the other end of the spectrum, lawmakers' well-intended attempts to use tax policy to help the working poor has not only added vast complexity, but unintentionally added features that can discourage poor people from working more as their incomes rise. A good example is the way in which the Earned Income Tax Credit phases out as a worker's income increases. Consider this another hidden success tax.

The EITC calculation formula includes four phase-in rates, four phase-out rates, and different calculations based on filing status and number of children. It is no surprise that Americans made 219,122 math errors when calculating the EITC in 2014, or that the credit had an improper payment rate of between 22 and 26 percent in 2013.⁴

The complex structure of the EITC has the ironic effect of encouraging more work as the subsidy phases in, but then it discourages work effort as the subsidy phases out by levying high marginal tax rates on households just over the poverty line. When a married household with two children begins to earn more than \$23,630, the EITC starts to phase out at a rate of 21.06 percent. This high phase-out rate has the perverse effect of penalizing a worker for every dollar they earn above the poverty line, thus discouraging that extra work effort.

We can measure the macroeconomic cost of this phase-out penalty by substituting a different phase-out rate. For example, substituting a uniform 10 percent phase-out rate for the current 21.06 percent phase-out rate reduces the penalizing marginal tax rate effect on working households. When we compare the economic effects of these two systems, the TAG model finds

⁴ Internal Revenue Service, *Data Book*, 2015, <https://www.irs.gov/pub/irs-soi/15databk.pdf>; Treasury Inspector General for Tax Administration, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act*, 2014, <https://www.treasury.gov/tigta/auditreports/2014reports/201440027fr.pdf>

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that the current system reduces long-run GDP by 0.1 percent, lowers the after-tax incomes of the working poor by more than 1 percent, and costs the equivalent of 164,000 full-time jobs.

Itemized Deductions

For middle-income households, one of the most complex areas of the tax code is itemized deductions. Only 30 percent of taxpayers choose to itemize their deductions, but it is likely that many other households devote significant time and energy determining whether it would be advantageous or not to itemize.

Deductions also narrow the tax base which, in turn, often requires higher tax rates to raise a comparable amount of revenues as would a broader base with lower rates.

Certainly, one way to simplify the tax code and broaden the tax base is to simply eliminate many of these itemized deductions. However, eliminating itemized deductions alone could actually produce harmful macroeconomic effects, as this would bump some taxpayers into higher brackets, increasing their marginal tax rates, and discouraging work and investment.

For example, the TAG model indicates that the marginal rate effects of simply eliminating all itemized deductions except for the charitable and mortgage interest deductions would lead to a long-term reduction in GDP of 0.4 percent and the loss of 290,000 full-time equivalent jobs.

Swap itemized deductions for lower rates. However, there are significant economic benefits to lowering tax rates while broadening the tax base. For example, if the additional revenue from eliminating those same itemized deductions were then used to cut every income tax rate by 10 percent, this would increase long-run GDP by 0.6 percent and create 577,000 full-time equivalent jobs.⁵ These gains represent the true cost of our current narrow tax base combined with high tax rates.

Double the standard deduction. Another way of simplifying the tax code while reducing reliance on itemized deductions is to expand the standard deduction. A larger standard deduction would mean that fewer taxpayers would feel the need to keep detailed records of their expenses and fill out Schedule A.

A larger standard deduction could be economically beneficial, by bumping many households into lower marginal rates. The TAG model shows that doubling the standard deduction for all households would increase long-run GDP by 0.5 percent and create 463,000 full-time equivalent jobs.

Estate and Gift Taxes

Another unduly complicated area of the tax code aimed at stemming income inequality is the federal estate and gift tax. Albeit a minor source of federal revenues—it collected \$19 billion in 2014, just 0.6 percent of federal receipts—it has outsized economic effects because it strongly depresses capital formation relative to the modest amount it collects. We estimated that just the costs associated with complying with the estate tax now exceed the revenue it generates.

Advocates say that it impacts very few estates since the first \$5.45 million of gifts and bequests is excluded from tax, and the amount is indexed for inflation. Thus, they say, it has

⁵ For this example, it was necessary to eliminate the AMT because the loss of so many itemized deductions threw many taxpayers into the AMT.

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minimal economic effect. However, many economists say that by making it harder to pass family businesses and farms to the next generation, the estate tax is yet another "success tax."

The TAG model finds that the federal estate and gift tax depresses the long-run level of GDP by 0.8 percent, lowers wages by 0.7 percent, and costs 159,000 full-time equivalent jobs.

Business Income Taxes

It is now well known that the U.S. has the highest corporate income tax among the leading industrialized nations. Indeed, Tax Foundation economists determined that the U.S. has the third highest corporate income tax among the 165 nations we surveyed. Only Chad and the United Arab Emirates levied a higher corporate tax rate than the U.S.

Economists at the OECD determined that the corporate income tax is the most harmful tax a nation can impose because capital is the most mobile factor in the economy and, thus, the most sensitive to taxation. Individual income taxes were found to be second-most harmful, followed by sales taxes, and then property taxes.

One way of measuring the economic costs of our high corporate tax rate is simply to lower the rate in our TAG model. For example, the model shows that cutting the corporate tax rate to 25 percent from 35 percent (with no offsets) would boost the long-term level of GDP by 2.3 percent, increase wages by 1.9 percent, and create 443,000 full-time equivalent jobs. These potential gains represent the economic cost of our uncompetitive corporate tax rate.

Aside from our uncompetitive corporate tax rate, there are many complex elements of the corporate code that have harmful effects too. We can estimate those costs as well.

Cost Recovery

Under the current tax code, when a business makes a capital investment, it is required to deduct the cost of that asset over time, following one of more than a dozen depreciation schedules. These schedules are essentially arbitrary, and the process of determining how to properly depreciate an asset is complex.

One tax code change that could make the tax code both less complex and more favorable to investment is moving to full expensing of capital investment. Allowing businesses to deduct the full cost of their investments immediately would encourage significantly higher investment levels and make hundreds of pages of tax code unnecessary.

According to the TAG model, full expensing would increase the long-run level of GDP by 5.4 percent, by growing the nation's capital stock by 16 percent, increasing wages by 4.5 percent, and creating more than 1 million full-time equivalent jobs. Again, these potential gains illustrate the economic costs of our current depreciation schedule.

Dollar-for-dollar, full expensing is one of the most pro-growth tax simplifications that Congress could enact.

Corporate Integration

Another complex feature of the business tax code is that firms face significantly different tax regimes depending on their legal form. For instance, traditional C-corporations typically face a much higher marginal tax burden than partnerships because corporate income is taxed twice,

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first at the entity level at 35 percent, and then at the shareholder level when capital gains and dividends are taxed at rates as high as 24 percent. Partnership and S-corporation income is taxed only once when the profits are distributed to the owner.

Over the past few decades, there have been several notable proposals to equalize the tax treatment of all businesses, regardless of their legal form or financing method. This approach is known as corporate integration, and it would vastly simplify the taxation of U.S. businesses. Under corporate integration, companies would no longer have to spend time and resources determining what legal form to adopt or planning tax-efficient financing strategies.

Recently, the Tax Foundation modeled a version of corporate integration that would allow corporations to deduct dividends paid and would tax dividends received by individuals at ordinary income rates. By eliminating one layer of corporate tax, and greatly simplifying the business tax code, such a proposal would increase U.S. GDP by 2.9 percent over the long run, boost wages by 2.5 percent, and create 535,000 full-time equivalent jobs.

Business Tax Expenditures

There are roughly 80 so-called tax expenditures in the corporate tax code, with an annual budgetary value of more than \$120 billion. It's often thought that businesses and the economy would be better off if all of those tax breaks were eliminated in exchange for a lower corporate tax rate. However, our research indicates that lawmakers must be very selective if they chose to eliminate business tax expenditures in exchange for a lower tax rate, or they risk negating the economic benefits anticipated from the rate cut itself.⁶

The reason for this is that a number of corporate tax provisions—such as accelerated depreciation and the expensing of research and development costs—help move the tax code towards a more neutral treatment of capital investment. Eliminating these cost-recovery provisions raises the cost of capital and, thus, neutralizes any of the economic benefits of a lower tax rate.

However, there are many other tax preferences—such as energy credits, or interest exclusions on bonds—that could be eliminated with minimal economic harm and provide revenue for overall rate cuts.

For instance, eliminating all business tax expenditures that are not connected to cost recovery would raise enough revenue to cut the overall corporate tax rate to 28 percent. This combination of rate cuts and base broadening would increase the size of the U.S. economy by 1.4 percent in the long run and create 275,000 full-time equivalent jobs. Moreover, the new economic growth would actually increase federal revenues by more than \$550 billion over a decade.

International Taxation

Perhaps the most complex aspect of the U.S. tax code is the treatment of income earned overseas. Under current law, U.S. multinational corporations are required to pay tax on their worldwide income. If a corporation earns profits in England, it is required to pay a 20 percent tax rate on those profits to Her Majesty's Revenue and Customs. As long as that company

⁶ Scott A. Hodge, "The Challenges of Corporate-Only Revenue Neutral Tax Reform," Tax Foundation *Fiscal Fact No. 471*, June 18, 2015.

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keeps any residual profits overseas, it can defer the additional payment of U.S. tax. Once that corporation decides to bring those profits back to the United States, it is required to pay tax again to the U.S. government at 35 percent, minus a tax credit for the 20 percent paid to the U.K.

Major complexities arise for multinational corporations operating abroad. The foreign tax credit, which is intended to prevent double-taxation of foreign profits, is littered with rules and exceptions that can limit which taxes that businesses pay overseas can be credited against U.S. tax liability. In the past, the IRS has used these rules to deny foreign tax credits to multinational corporations. This leads businesses to go to court against the IRS, costing time and resources.

Most nations do not require this level of complexity. Instead, they have territorial tax systems, which only require domestic multinationals to pay tax to the countries in which they conduct their business. These systems make the foreign tax credit rules unnecessary and eliminate much of the complexities of our worldwide system.

Tax Foundation economists are currently developing an extension of our TAG model to measure the economic and revenue effects of moving to a territorial tax system.

Lessons from Modeling Tax Reform Plans

Over the past year, Tax Foundation economists have gained special insights into what kind of tax policies boost investment, wages, jobs, and economic growth, and which policies lead to a reduction in those indicators.

Using our Taxes and Growth (TAG) Macroeconomic Tax Model, we have scored the tax plans of every presidential candidate,⁷ as well as numerous tax plans developed by members of the House and Senate. During this experience, we have modeled every conceivable tax reform plan, including the Flat Tax, FairTax, Bradford X-Tax, Value Added Tax (VAT), and numerous others that incorporate features of each of these.

To one degree or another, the more pro-growth of these plans incorporate many of the lessons that I've outlined in the first portion of this testimony: they reduce marginal tax rates; reduce taxes on capital; reduce or eliminate the double-taxation of savings and investment; and, move toward a neutral or consumption tax base.

Here are four examples:

Senator Ben Cardin's Progressive Consumption Tax⁸

Senator Ben Cardin's proposal would dramatically scale back the individual and corporate income taxes. Because the plan would exempt a couple's first \$100,000 of wages from the income tax, most people would no longer owe the individual income tax. Incomes above that amount would be subject to rates of 15, 25, and 28 percent. The corporate income tax rate would be cut to 17 percent.

The Cardin plan is intended to be revenue neutral. He would finance this with a value added

⁷ These scores can be found at: <http://taxfoundation.org/blog/comparison-presidential-tax-plans-and-their-economic-effects>

⁸ Michael Schuyler, "An Analysis of Senator Cardin's Progressive Consumption Tax," Tax Foundation Fiscal Fact No. 473, July 8, 2015. <http://taxfoundation.org/article/analysis-senator-cardin-s-progressive-consumption-tax>



tax, which he calls the Progressive Consumption Tax (PCT). Large rebates would make the overall package progressive.

At a PCT tax rate of 10 percent, the TAG model estimates that in the long run the plan would raise the level of GDP by 4.4 percent, increase the stock of capital used in production by 15.2 percent, and boost the number of full-time equivalent jobs by 1.1 million.

Ben Carson's Flat Tax⁹

During his presidential bid, Dr. Ben Carson proposed to replace the current federal income tax (both individual and corporate) with a Hall-Rabushka-style flat tax. The plan would tax all wage income and business income at 14.⁹ percent, but exempt taxes on capital gains, dividends, and interest income at the individual level.

Businesses would be allowed to fully expense capital investment, but would no longer be able to deduct interest expenses. The plan would also eliminate all itemized deductions and all tax credits except for the foreign tax credit. The plan would further expand the tax base by including fringe benefits, such as employer-provided health insurance.

Our analysis found that the plan would reduce federal revenues by \$2.5 trillion over the next decade. However, it also would improve incentives to work and invest, which would increase GDP by 16 percent over the long term if the tax cuts were appropriately financed. This increase in GDP would translate into 10.9 percent higher wages and 5.2 million new full-time equivalent jobs.

The Lee-Rubio Tax Reform Plan¹⁰

In March 2014, Senators Mike Lee and Marco Rubio introduced a comprehensive tax reform plan. While the plan has attracted a great deal of attention for its generous child tax credits, the structure of the plan incorporates the core planks of David Bradford's "X-Tax," or progressive consumption tax.¹¹ The Lee-Rubio plan achieves this by cutting both corporate and pass-through business tax rates to 25 percent, moving to full expensing for all capital investment, eliminating the second layer of corporate taxation by repealing taxes on dividends and capital gains, and moving to a full territorial tax system. For individuals, the plan taxes wages at rates of 15 and 35 percent.

According to the Tax Policy Center, these measures reduce the marginal effective tax rate on new investment to zero. The Tax Foundation's model estimates that the Rubio plan would boost the long-term level of GDP by roughly 15 percent, and the capital stock by 49 percent, which, in turn, would raise wages by 12.5 percent and create 2.7 million new full-time equivalent jobs. We also found that the plan would reduce federal tax revenues by \$2.4 trillion over a decade.

⁹ Kyle Pomerleau, "Details and Analysis of Dr. Ben Carson's Tax Plan," Tax Foundation Fiscal Fact No. 493, January 6, 2016. <http://taxfoundation.org/article/details-and-analysis-dr-ben-carson-s-tax-plan>

¹⁰ Michael Schuyler and Will McBride, "The Economic Effects of the Rubio-Lee Tax Reform Plan," Tax Foundation Fiscal Fact No. 457, March 9, 2015. <http://taxfoundation.org/article/economic-effects-rubio-lee-tax-reform-plan>

¹¹ The corporate side of the Lee-Rubio plan shares many similar components to the Nunes tax plan. <http://taxfoundation.org/article/updated-details-and-analysis-nunes-plan-reform-business-taxation>

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Ted Cruz's Tax Plan^{12,13}

The plan proposed by Senator Ted Cruz takes a different approach to get to nearly the same place as these other tax reform plans. The plan would replace the corporate income tax and all payroll taxes with a 16 percent "Business Flat Tax," or VAT. This allows for the full expensing of all capital investment, but shifts the tax burden away from capital to labor. Cruz compensates workers for this shift by creating a single individual tax rate of 10 percent and expanding the EITC.

The Tax Foundation's model estimates that the Cruz plan would boost the long-term level of GDP by 14 percent. This is slightly less growth than the Lee-Rubio plan because it does not eliminate the second layer of tax on corporate income. Still, the plan would increase the capital stock by 44 percent and wages by 12 percent. And because the 10 percent individual flat tax rate would encourage more people to enter the workforce, Cruz's plan would create nearly 5 million full-time equivalent jobs. We also estimate the plan would reduce federal revenues by \$758 billion over a decade.

Conclusion

A few years ago, the National Taxpayer Advocate named tax complexity the number one issue facing American taxpayers. In addition to robbing us of 8.9 billion hours of our lives complying with its Byzantine rules, our complex tax system punishes success and hard work, thus, robbing the economy of its ability to create jobs and better living standards.

Using the Tax Foundation's Taxes and Growth (TAG) Macroeconomic Tax Model, we are able to measure and quantify the cost of complex tax provisions on GDP, investment, and jobs. We find that the complexity caused by measures designed to make the tax code more progressive shrink the economy and kill jobs. We find that the complexity caused by tax policies to help the poor can discourage work and shrink wages. We find that the extremely complex corporate income tax—from its high rate, badly designed cost recovery systems, and twin layers of taxation—leads to less investment, fewer jobs, and a smaller economy.

Finally, by scoring a wide variety of tax reform plans with our TAG model, we learned that there are many valid ways of ridding the tax code of its worst parts and creating a tax system that boosts economic growth, creates jobs, and lifts living standards.

I hope that the members of this committee, as well as your fellow lawmakers, take these lessons to heart and start us down the road to fundamental tax reform soon.

Thank you for your time. I welcome any questions that you may have.

¹² Kyle Pomerleau and Michael Schuyler, "Details and Analysis of Senator Ted Cruz's Tax Plan," Tax Foundation *Fiscal Fact* No. 489, October 29, 2015. <http://taxfoundation.org/article/details-and-analysis-senator-ted-cruz-s-tax-plan>

¹³ Rand Paul's tax plan was very similar to Cruz's plan. See: Andrew Lundeen and Michael Schuyler, "The Economic Effects of Rand Paul's Tax Reform Plan," Tax Foundation Blog, June 18, 2015. <http://taxfoundation.org/blog/economic-effects-rand-paul-s-tax-reform-plan>

10 Appendix

Estimate Hourly and Compliance Costs of IRS Paperwork in 2016

Form/Title	Total Annual Hours Burden	Total Annual Cost In Dollars
IRS Total	8,906,390,150	\$409,241,340,626
Most-Costly Code Provisions		
U.S. Business Income Tax Returns (2)	2,832,500,000	\$147,431,625,000
U.S. Individual Income Tax Returns (1)	2,647,000,000	\$98,680,160,000
Income Tax Returns for an S Corporation (2)	889,393,518	\$46,292,932,612
Form 4562--Depreciation and Amortization (2)	448,368,447	\$23,337,577,666
Employer's Quarterly Federal Tax Return (2)	388,256,964	\$20,208,774,976
Income Tax Returns for Estates and Trusts (2)	375,796,476	\$19,560,206,576
Form 940, FUTA Tax Return (2)	105,295,370	\$5,480,624,009
Form 4797--Sales of Business Property (2)	100,633,248	\$5,237,960,558
Schedule C: Profit and Loss from Business (1)	71,701,693	\$2,673,039,115
Form 1099-INT, Interest Income (1)	63,059,438	\$2,350,855,849
Proceeds from Broker and Barter Exchange Transactions (2)	49,396,988	\$2,571,113,225
IRA Contribution Information (1)	48,731,780	\$1,816,720,758
Short Form Return of Exempt Organizations (1)	43,656,636	\$1,627,519,390
Taxation of Fringe Benefits (2)	37,922,688	\$1,973,875,910
Distributions from Pensions, Annuities, IRAs (1)	37,519,860	\$1,398,740,381
All remaining IRS regulations (1)	767,157,044	\$28,599,614,600

Source: Reginfo.gov and author calculations based on BLS December 2015 estimate of hourly compensation costs. (1) \$37.28 for all full-time private sector workers, (2) \$52.05 for professional and related workers. <http://www.bls.gov/news.release/ecec.t11.htm>

Chairman BOUSTANY. Dr. Sullivan, you may proceed.

**STATEMENT OF DR. MARTIN SULLIVAN, CHIEF ECONOMIST,
TAX ANALYSTS**

Mr. SULLIVAN. Good afternoon, Chairman Boustany, Ranking Member Neal, Members of the Committee, thank you for the privilege of appearing before you today.

Tax reform presents many challenges for this subcommittee, but I believe in the current environment, the most critical of these challenges is reducing the harmful economic effects of the corporation tax, and doing so in a manner that is both fiscally responsible and does not reduce the progressivity of the tax system.

Economists of all stripes have long recognized the shortcomings of the corporate tax, but in recent times, these problems have gotten much worse. In the olden days, these fellows will remember, the economic damage caused by the corporate tax was relatively small. The concern back then was that a U.S. corporation like GM or GE might reduce capital spending by a few percentage points if we raised the corporate tax. And in the olden days, most of the burden of the corporate tax was on shareholders who were at the top of the income scale.

In our modern globalized economy, job-creating capital is highly mobile. Now, high corporate tax rates can induce both domestic and foreign multi-nationals to shift large chunks of their production and research out of the United States, and as a result, the burden of the corporate tax now falls increasingly on workers in the form of lost jobs and lower wages. And over time, these ill effects will only get worse.

The rest of the world understands this. Every other major country has reduced its corporate tax rate. Most notably, in its latest budget, the United Kingdom has announced it will cut its corporate rate to 17 percent by 2020. In stark contrast, taking into effect State corporate taxes, the U.S. corporate tax rate is over 39 percent, the highest in the world.

Criticizing the corporate tax is very easy. The hard part is figuring out how to pay for a lower corporate rate. The tepid response to Chairman Camp's tax reform plan pretty much proves that revenue neutrality within the corporate sector is not a useful guiding principle for 21st century tax reform. To promote long-term growth, we need to downsize our most economically damaging tax and substitute it with revenue from other sources.

One option would be for the United States to follow the example of other nations and adopt a value-added tax. It would greatly enhance U.S. competitiveness if we could replace revenue from the capital-repelling corporate tax with a highly efficient consumption tax.

Alternatively, replacing the corporate tax with a business cash flow tax with border tax adjustments, as proposed by President Bush's tax reform panel in 2005, would entirely eliminate the tax incentive to shift production out of the United States.

Another job-creating approach would be to shift tax away from corporations and on to investors by increasing taxes on capital gains and dividends. The reason for doing this is simple. When you raise taxes on corporations, investments—investment moves to

lower tax jurisdictions. When you raise taxes on investors, they could move, but they usually don't.

Yet another approach for improving international competitiveness would be to raise taxes on immobile capital, such as real estate, to pay for reductions on mobile capital such as investment and manufacturing.

On the international side, we need to banish the lockout effect from our international tax rules. To the extent we impose tax on foreign profits, we should levy that tax as profits are earned, not when they are distributed to the U.S. parent. We also need tough earning stripping rules. It makes no sense that foreign headquartered multinationals doing business in the United States should be tax advantaged over U.S. companies. We should also consider, as both President Obama and Donald Trump have proposed, limiting deductions on excessive corporate borrowing. This would equalize the treatment of corporate debt and equity, and provide revenue for reducing the corporate tax rate.

In conclusion, I would like to stress, for the economy's sake, corporate tax reform should be both fiscally responsible and bipartisan. Corporate rate cuts should be fully paid for on a permanent basis without gimmicks or overly optimistic assumptions about growth and dynamic scoring.

Reckless budgeting not only spooks the bond markets, it greatly dilutes the positive supply side effects of business tax cuts because there is a high probability those cuts will be rescinded when the rosy budget scenarios are not realized. And when it comes to corporate taxation, we don't need a seesaw battle between the political left and the political right. If one party is able to enact its tax agenda by a narrow margin, there is a high probability there will be a major change right after the next election.

Corporate tax reform should be bipartisan, not simply because it is nice for both parties to get along, but because tax policy that is the outcome of bipartisan compromise reduces uncertainty, and uncertainty is a major impediment to investment and long-term economic growth.

Thank you, Mr. Chairman. I will be glad to answer any questions.

[The prepared statement of Dr. Sullivan follows:]

Embargoed Until Delivery

**Testimony of Martin A. Sullivan, Ph.D.
Chief Economist,
Tax Analysts¹**

**Before the Subcommittee on Tax Policy of the
Committee on Ways and Means,
U.S. House of Representatives**

May 25, 2015 2p.m.

Perspectives on the Need for Tax Reform

Good afternoon, Chairman Boustany, Ranking Member Neal, and Members of the Committee. It is an honor and a privilege to appear before you today to discuss perspectives on the need for federal tax reform. I will focus my attention on how U.S. tax laws can be changed to improve the current and future living standards of Americans through economic growth, business expansion and job creation.

Any critical review of the effect of U.S. tax laws on economic growth must focus on the corporation tax because the corporation tax is our most economically damaging tax. Tax reform presents many challenges for this subcommittee but I believe in the current environment the most critical of these is reducing the harmful economic effects of the corporation tax in a manner that is both fiscally responsible and does not reduce the progressivity of the tax system.

Though it has been a salient feature of the income tax since its inception, there is no economic justification for an elaborate set of rules that potentially subjects business profits to a second level of tax. All types of distortions that hurt our economy are the result. There is less capital formation. Businesses both large and small do everything possible to qualify for passthrough status. Corporations have a large tax incentive to issue debt, and equity-financed businesses are put at a competitive disadvantage with firms that borrow. And in order to defer tax at the individual level corporations have a bias in favor of retaining earnings over paying dividends to shareholders.

We have long understood these problems with the corporate tax, but they have been tolerated because the corporate tax is a large and politically expedient source of revenue. The Congressional Budget Office projects the corporate tax will raise \$4 trillion over the next decade. It will not be easy to find offsetting revenues to replace even a fraction of that total. Just as daunting as the revenue problem is the public's perception of the corporate tax. Despite its

¹ The views here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

considerable economic shortcomings, there is deep-seated feeling shared by most Americans that big business is not paying its fair share of taxes.

In the modern globalized economy our old-fashioned tolerance of the corporate tax and willingness to retain a high corporate tax rate is not doing us any favors. In the past our main concern with the corporate tax's effect on capital formation was that it would reduce the amount of capital formation performed by U.S. firms who did most of their investing in the United States anyway. Though there was a lot of dispute (as there always is) among economists, most studies showed that back then the corporate taxes had only a modest effect on U.S. capital formation.

Globalization has changed all that. Now capital is far more mobile over international borders. This means that even if the corporate tax has a small effect on the overall amount of capital spending, it can still have a large effect on where that capital is located. In other words, our main concern is not that a firm will *reduce* its capital spending but that it will *shift* its capital spending outside the United States.

Because business are more likely to shift the location of capital spending that reduce the overall level of capital spending, the detrimental effects of the U.S. corporate tax on capital formation in the United States have grown significantly. With reduced domestic production there are fewer jobs for American workers. With less domestic capital formation, productivity and wages decline. And so now the burden of the corporation tax is not just a burden on owners of capital concentrated at the upper-end of the income scale but on American workers as well.

Other countries around the world have responded to competitive pressures of globalization by reforming their corporate taxes and lowering their corporate tax rates. Meanwhile, by standing still the United States has fallen behind. It is puzzling why the United States with its strong capitalist and low-tax traditions has not followed suit. Perhaps it is the increasing partisan gridlock in the United States that makes sweeping legislation like tax reform difficult to pass. Perhaps it is the unwillingness of the U.S. Congress to consider adoption alternative revenue sources, such as a value-added tax. Whatever the reason, while all other major industrialized countries have reduced their corporate tax rates, the United States has refused to budge from the 35 percent rate that has been in place for the last 23 years. Taking into the account the effect of state taxes, the combined federal-state corporate tax rate exceeds 39 percent and is the highest in the industrialized world.

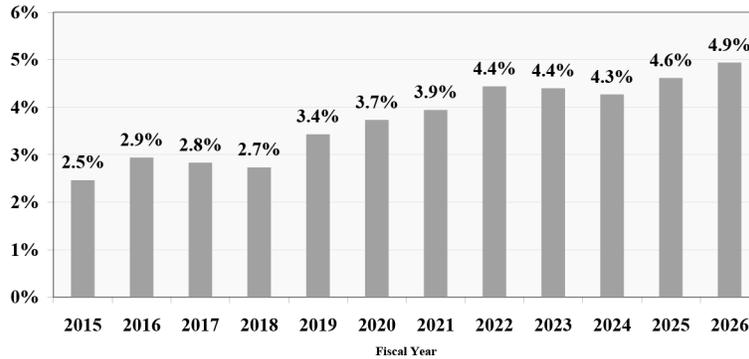
In addition to globalization and declining foreign tax rates, the OECD's BEPS project is providing the United States with yet another motivation for corporate tax reform. In essence, the OECD's BEPS project is telling governments that profits must be aligned with substantial value creation. As this principle becomes more widely adopted, we will be entering a new era where rate differentials take on heightened significance for the shifting of real business activity. The likely response by foreign parliamentary governments that can more easily change their tax laws will be further reductions in their corporate tax rates. Thus, the already problematic economic effects of a high U.S. corporate tax could be compounded by rate cuts of foreign governments responding to BEPS. Reducing the corporate tax rate has always been a top priority of U.S. economic policy. The BEPS project has raised the stakes.

The critical question is how do we pay for a lower corporate tax rate. It has been five years since Simpson-Bowles Commission put tax reform on the front burner. But since then there has not been one tax reform proposal that has come close to coming up for a vote in either the House or Senate tax-writing committees. The lukewarm response to former Ways and Means Committee Chairman Camp's prodigious tax reform efforts demonstrates the political obstacles to 1986-style tax reform that lowers the rates and broadens the base. There is no obvious Plan B. Worse still, at this time when the need for corporate tax reform has never been greater, the obstacles to corporate reform are growing.

Obstacles to Corporate Reform

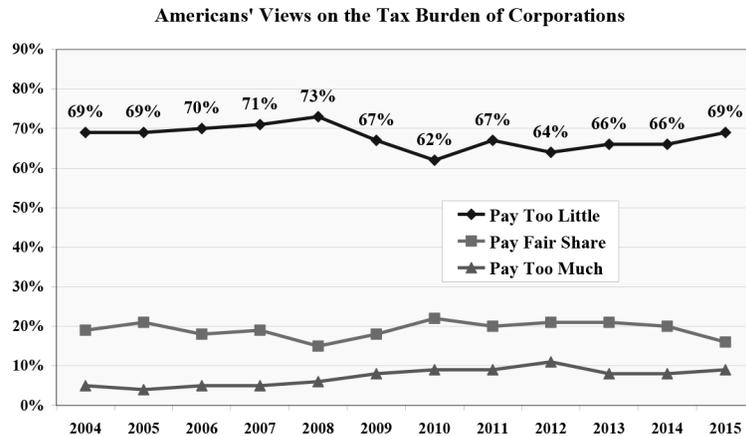
To make real progress on corporate rate reduction we will need to raise more revenue than can be raised from corporate base broadening. From an economic perspective there is nothing wrong with corporate tax reform that loses revenue as long as revenue losses are offset by cuts in inefficient spending or other tax increases. Unfortunately, we are rapidly running out of fiscal space that would make revenue-losing corporate reform possible. In the figure below, the Congressional Budget Office's latest baseline budget projections show that the federal deficit as a percentage of GDP will nearly double from 2.5 percent in 2015 to 4.9 percent in 2026. Debt held by the public will increase from \$14 trillion to \$24 trillion. This happens despite discretionary spending cuts from 6.5 percent of GDP in 2015 to 5.2 percent of GDP in 2026 already being baked into the forecast. If that isn't scary enough, projections for the following decades only continue to grow with the cost of entitlements.

**Latest CBO Federal Budget Deficit Projections
(Deficit as a % of GDP)**



Source: Congressional Budget Office, *Updated Budget Projections: 2016-2026*, March 24, 2016.

Another obstacle to corporate tax reform is American public's perception of corporate taxation. The figure below shows Gallup poll results indicating that on average over the last decade, seven out of 10 Americans believed American corporations were not paying their fair share of taxes. Similarly, a 2015 Pew Research poll found that 64 percent of Americans are bothered "a lot" by the belief that corporations are not paying their fair share of taxes.²



Source: Justin McCarthy, "More Americans Say Low-Income Earners Pay Too Much in Taxes," April 15, 2015, at www.gallup.com.

Despite these polling results, there is currently a lot of discussion of business-only tax reform. If Congress were to enact stand-alone business tax reform this would be a major break with the past. Except for some extensions of expiring provisions, in recent decades Congress has not enacted business tax relief unless it was accompanied by much larger tax cuts for individuals. Consider these historical events:

- The Economic Recovery Tax Act of 1981, signed into law by President Reagan, was projected to cut taxes by \$750 billion over the 1981-1986 period. Only 20 percent of those cuts were for business.
- The Tax Reform Act of 1986 achieved overall revenue neutrality by offsetting \$122 billion in individual income tax cuts over the 1986-1991 period with a nearly equal amount of corporate tax increases.
- The Taxpayer Relief Act of 1997 offset approximately \$390 billion of tax cuts over the 1997-2007 period with \$116 billion in tax increases. All the tax cuts were reductions in individual income and estate taxes.

² Seth Motel, "5 Facts on How Americans View Taxes," April 10, 2015, at <http://www.pewresearch.org>.

- The Economic Growth and Tax Relief Reconciliation Act of 2001, signed into law by President George W. Bush, cut taxes by \$1.35 trillion over the 2001-2011 period. Except for \$138 billion of estate tax cuts, all the other tax relief came in the form of tax cuts for individuals.
- The American Recovery and Reinvestment Tax Act of 2009, signed into law by President Obama, cut taxes by an estimated \$326 billion over the 2009-2019 period. It included only \$6 billion of net non-energy business tax cuts and \$19 billion of energy tax cuts.
- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the Bush tax cuts for two years. The total estimated revenue cost was \$858 billion over 10 years. Only two significant business tax cuts were included: a \$1 billion extension of bonus depreciation and a \$13 billion extension of the research credit.
- On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012. Estimated to reduce revenue by \$3.9 trillion over the 2011-2021 period, this law permanently extended the Bush tax cuts for most taxpayers and greatly downsized the alternative minimum tax. Except for \$396 billion of estate tax relief, almost all of these cuts were for individual taxes.

So there you have it: Seven major changes in tax law, all with tax relief for individuals and all with relatively small amounts of business tax relief or with none at all. And it does not seem to matter which party is in the White House or in control of Congress. When it comes to actually making law, both Republicans and Democrats strongly favor individual over business tax cuts.

Rising Economic Populism

As difficult as it has been in the past to enact stand-alone business tax cuts, the political environment now is probably less favorable to business tax relief than at any time in living memory. This is an unexpected development. Just a few years ago a reasonable prediction would have been that business-only tax reform had good chance of enactment in 2017. After all, with ever-increasing international capital mobility and ever-declining corporate tax rates, isn't the economic case for cutting taxes on U.S. business operations more compelling than ever? Isn't it obvious that we should be following the lead of the United Kingdom which just announced its intention to reduce its corporate tax rate to 17 percent by 2020?

But 2016 has been anything but a normal year in American politics. As profits and stock prices hover near record levels, the United States is entering its third consecutive decade of stagnant wage growth. There are 5 million fewer American manufacturing jobs now than there were in 1990. Median income has flat-lined. The economy is not working for working-class Americans, and they are fed up. Long-simmering economic populism has been brought to a boil by the candidacies of Donald Trump and Bernie Sanders.

But it is not just Trump and Sanders who are sounding populist themes. All the major candidates for president in this election cycle—including conservative Republicans—are courting working class voters with lots of rhetoric complaining about corporate power and crony capitalism. A continuing barrage of press reports about large profitable corporations' aggressive tax avoidance has only contributing to the anti-corporate sentiment—further bolstering the public's opinion of corporations as not paying their fair share of taxes. The major implications of this for the

candidates' tax policies are wholesale attacks on tax breaks that favor the wealthy and large corporations and strong support for large tax cuts for low- and middle-income families. This latter development is a fundamental break with the supply-side economic theories that have dominated conservative thinking for the last three decades.

Whoever is the next president, he or she will have spent more than a year denouncing elites and promising tax relief for people who live paycheck to paycheck. It seems unlikely that he or she would prioritize a tax cut or a tax reform exclusively for the benefit of business. The 2016 election has provided an outlet for the latent anger of the working class, and it is unlikely the populist genie can be put back in the bottle when the election is over.

For those of us who place a high priority on corporate tax reform, this is not a hopeful picture. At this point it is hard to discern exactly what tax policies will address voters' discontent and improve living standards. I believe, however, there are several intriguing and economically uncontroversial ideas that have emerged from our recent tax reform debate that can be useful to Congress as it tackles the challenge of tax reform in 2017. These are listed below.

Some Guidelines for Tax Reform

It is better to tax shareholders than corporations. A decade ago, nobody would have believed that conservatives would ever advocate increased taxation on capital gains and dividends. But now it is increasingly accepted by economists and analysts of all political stripes that tax hikes on investors should be used to pay for tax cuts on corporations. The reason is simple: When you raise taxes on corporations, investment moves to a lower-tax jurisdiction. This lowers domestic productivity, wages, and employment. When you raise taxes on investors, investors can move, but usually they don't. Most people are unwilling to uproot families, leave friends, and adopt a new culture just to save taxes. And so with shareholder taxes, wealthy investors bear most of the burden rather than workers.³

Mobile activities should be taxed at lower rates than immobile activities. Economists have long known this as the Ramsey inverse elasticity rule: To promote economic efficiency, items

³ In a 2010 paper economists Rosanne Altshuler, Benjamin Harris, and Eric Toder explored the possibility of returning the top dividend and capital gains rates to their pre-1997 level of 28 percent. They made several interesting findings: First, most OECD countries have moved in the opposite direction of the United States and have raised shareholder tax rates while lowering corporate rates. Second, because the cross-border mobility of individuals is less than that of corporations, such a change would reduce tax distortions in economic decision-making. Third, because the burden of corporate taxation is believed to increasingly fall on labor, a shift in tax from corporations to shareholders would increase the progressivity of the tax system. ("Capital Income Taxation and Progressivity in a Global Economy," *Virginia Tax Review*, 2010, p. 355.) James Pethokoukis of the American Enterprise Institute has written: "Perhaps it is time for a new approach, with one economically obvious reform being a shift of corporate income taxation from the corporate level to that of the individual shareholders." Similarly, Alan Viard, also at the American Enterprise Institute, has stated: "We need to base our tax on where the stockholders live. We should give up this idea of taxing income at the corporate level, and instead say American shareholders should pay tax every year at full ordinary income rates on their dividends and their capital gains from any company no matter where the company is chartered or managed or where it earns its profits, and that tax should apply regardless of whether the stockholders sold the stock or not." (James Pethokoukis, "What to Do About US Firms Moving Overseas to Pay Lower Tax Rates?" Nov. 23, 2015. Includes quote from Alan Viard.)

that are less responsive to tax changes should be taxed at higher rates. Regular people instinctively understand this because they know that in a negotiation, the party that can walk away is in the stronger bargaining position. Mobile international businesses have choices. So if a country on a limited budget wants to attract as much foreign capital as possible, it will do better "spending" its tax relief dollars on mobile rather than immobile capital.

The tough part for governments wishing to implement this approach is drawing an administrable line between business activities that are mobile and immobile. If a multinational wants to sell its products in a country with a large and lucrative local market, to promote national welfare (that is, collect maximum revenue with minimal loss of jobs), a market country ideally will impose high taxes for market access. On the other hand, because manufacturing is often highly mobile, countries will go to great lengths to attract the manufacturing jobs and investment. In this case, to promote national welfare (that is, create maximum jobs with minimal loss of revenue), a source country will cut taxes to the bone to encourage businesses to locate factories in its borders.

One clearly immobile investment is real estate. One revenue-neutral approach to tax reform that would take advantage of the Ramsey rule would be to pay for tax cuts on mobile manufacturing with offsetting tax increases on real estate investment, such as reducing the home mortgage interest deduction and limiting like-kind exchanges.⁴

Border tax adjustments eliminate incentives to relocate investment. A border-adjusted consumption tax exempts exports and includes imports in the tax base. Most value added taxes and some cash flow business taxes have border tax adjustments. For decades policymakers have focused on the potential benefit to the balance of trade from border tax adjustments. (Most economists dismiss these trade effects because they expect any tax effects to be offset by exchange rate adjustments.)

With increased mobility of international capital, attention is now focused on the effects of border tax adjustments on the location of investment rather than on their effects on trade. The striking feature of a cash flow business tax with border tax adjustments is that unlike a source-based income tax, it has no effect on the location of investment. All goods destined for the U.S. market would be subject to tax no matter where produced. All goods destined for foreign markets would be exempt from tax no matter where produced. This means that if the United States replaced its corporate tax with a cash flow tax with border tax adjustments (as proposed by President George W. Bush's tax reform panel in 2005), the United States would leapfrog from one of the least attractive to one of the most attractive countries in the world for locating manufacturing.

Foreign profits should be subject to U.S. tax as those profits are earned. Deferral of U.S. tax on unrepatriated foreign profits has been a central feature of the U.S. corporate tax since its inception. It has long had the strong political support of the business lobby because it has provided U.S. multinationals with a tax benefit for operating abroad. But as a result of check-the-box regulations and expert tax planning, deferral has resulted in an unsightly multitrillion-dollar buildup of unrepatriated foreign profits.

⁴ Martin A. Sullivan, "The Simple Economics of Like-Kind Exchanges," *Tax Notes*, Aug. 3, 2015, p. 491.

It is yet to be determined how heavily or lightly foreign profits will be taxed in any future U.S. international tax reform. At one extreme, some liberals want a pure worldwide system in which profits are taxed as they are earned at a 35 percent rate. At the other extreme, some conservatives want a pure territorial system in which foreign profits from active business are not taxed at all. In between are the majority of folks who want international tax rules that allow U.S. corporations to remain competitive in foreign markets but at the same time remove planning opportunities that encourage shifting of profits and jobs out of the United States.

Waiting to tax profits until they are distributed to the U.S. parent adds needless complexity and inefficiency to the tax law. Whatever burden Congress wants to impose on foreign profits, it can achieve the same general effect by adjusting the tax rate on foreign profits without retaining deferral and the lockout effect.

There are good reasons to limit deductions on debt. It is now widely accepted that there must be limitations of related-party lending to prevent profit shifting to low-tax jurisdictions. Concern about related-party debt is what prompted the OECD last year to propose limitations on intergroup borrowing in action 4 of its base erosion and profit-shifting project and Treasury in April to issue proposed regulations under section 385 that would recharacterize certain types of related-party debt as equity.

More generally, economists have long bemoaned the large tax advantages of corporate investment financed with debt over investment financed with equity. There is no question that interest is a legitimate business expense in the determination of corporate profits.⁵ But the corporation tax is an arbitrary tax on corporate capital income paid to shareholders. When economists propose limiting corporate interest deductions, they are seeking to make corporate tax less distortionary by expanding the corporate tax base to include capital income paid to bondholders.⁶

Given that tax neutrality and financial stability are both noncontroversial policy goals, favoritism of debt over equity in our current system makes no sense. In fact, negative effective tax rates are common for debt-financed investment. In addition to the economic arguments to limiting interest, proposals to limit interest deductibility on debt are gaining attention because other, more conventional revenue raisers to pay for lowering the corporate rate do not have widespread support in the business community or in Congress.

The Obama administration has suggested limiting interest deductions as part of its 2012 business tax reform framework and its updated framework in April of 2016. Donald Trump has proposed limitations on interest deductions. Former Florida Gov. Jeb Bush and Sen. Marco Rubio, R-Fla., had proposed eliminating business interest deductions entirely as part of their plans to replace the corporate tax with a business cash flow tax.

⁵ Jonathan Talisman, "Do No Harm: Keep Corporate Interest Fully Deductible," *Tax Notes*, Oct. 14, 2013, p. 211.

⁶ Martin A. Sullivan, "Treat Corporate Interest Deductions Like Any Tax Expenditure," *Tax Notes*, Aug. 6, 2012, p. 631; and Robert C. Pozen and Lucas W. Goodman, "Capping the Deductibility of Corporate Interest Expense," *Tax Notes*, Dec. 10, 2012, p. 1207.

The infrastructure funding gap is growing and can no longer be ignored. Ronald Reagan increased the federal gas tax in his first term and was reelected in a landslide. Bill Clinton increased the federal gas tax in 1993 and was reelected in a landslide. Despite this, modern-day politicians of both parties simply refuse to consider the most obvious method of replenishing the federal government's shrinking pool of funds to pay for infrastructure.

This is economic malpractice on the part of Congress. Infrastructure spending is good demand-side economics. It directly stimulates employment in construction firms and in all the suppliers and support services for construction projects. Infrastructure spending is also good supply-side economics. It increases domestic capital formation, which increases productivity and long-term growth.

Many believe that government spending on infrastructure would contribute to the financial instability of the government at a time when deficits are growing. Here is where our archaic system of government accounts does lawmakers and the public a monumental disservice. We focus obsessively on government bonds, notes, and bills issued by the treasury as though the only thing the government did was issue debt to buy candy bars. We ignore almost every other asset and liability on the government's balance sheet, including unfunded pension liabilities, land, gold, foreign currency reserves, the right to the electromagnetic spectrum, and -- the subject of our current discussion -- roads, bridges, tunnels, and waterways.

In our current system of accounting, we do not tabulate the losses from depreciation of publicly owned infrastructure. And we do not acknowledge the positive contribution to the economy and to government net worth when governments spend on building and capital maintenance.

Somehow we must soon figure out how to pay for more spending on infrastructure. The most discussed alternatives are mostly about shifting costs: more privatization, devolution to the states, an infrastructure bank, new tax-exempt bonds, user fees based on mileage instead of fuel consumption. Yes, some of these are more efficient methods of collecting and distributing funds, but for the most part they do not change the fundamental problem that makes politicians cringe: the public will have to pay more.

Tax on deemed repatriations is an efficient tax. As part of a broader overhaul of our international tax rules, Chairman Camp's proposal to apply a one-time tax on the stock of accumulated foreign earnings (so called "deemed repatriation") should not only be fully embraced, it should be expanded. Under the Chairman Camp's plan unrepatriated foreign earnings currently held as cash would be taxed at 8.75 percent and other unrepatriated earnings invested in active business would be taxed at 3.5 percent. The Joint Committee on Taxation estimated this proposed would raise \$170 billion over ten years. From an economic perspective, this is about the most efficient tax possible—even better than a consumption tax—because as a tax on old capital it does not affect incentives to invest on a going forward basis. Therefore, in order to pay for rate cuts and tax incentives that would promote domestic capital formation and job growth, in addition to tough base protection measures that limit profit shifting to low-tax countries, Congress should give high priority to the a deemed repatriation proposal with rates considerably higher than those proposed by Chairman Camp.

Tax simplification is especially important to small business. Small businesses spend about 1.75 billion hours and \$16 billion annually on income tax compliance.⁷ Most of the time burden is for record keeping. And most of the financial burden is in paying for professional help. What about differences in cost by firm size? Estimates shown in the figure below confirm what common sense would have us assume: small businesses face significant fixed compliance costs, and cost per employee decreases with firm size.

The figure demonstrates the need for small business tax simplification. The inordinately large compliance costs faced by small businesses place a tax penalty on them that is the economic equivalent of a tax surcharge for being small. That distorts the allocation of capital away from small businesses and reduces economic growth.

Of course, everybody wants a simpler tax system. But tax simplification is especially important to small businesses. In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small business.

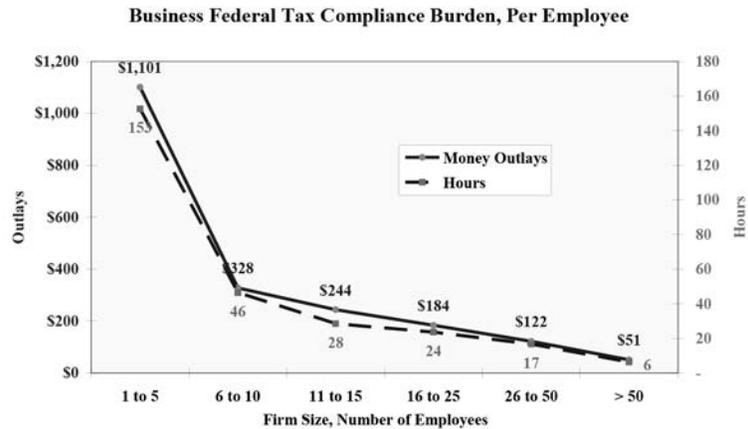
One particularly promising approach for small business tax simplification would be expansion of cash accounting methods used to compute income tax. David Kautter and Donald Williamson have proposed that small business recognize income and deductions only when cash is received or expenses are paid.⁸ This proposal includes the elimination of calculations for depreciation and cost of goods sold, which the authors believe will not reduce government revenue and will increase compliance among small businesses and entrepreneurs. This is just one in a long line of proposals for simplified accounting for small business.⁹

In-depth examination of tax rules required to achieve small business tax simplification is neither easy nor glamorous. But it is one surefire way to reduce business costs and promote economic growth with minimal damage to the deficit.

⁷ Donald DeLuca, John Guton, Wu-Land Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance Burden for Small Businesses," Proceeding of the 2007 IRS Research Conference, IRS Research Bulletin, 2007.

⁸ David Kautter and Donald Williamson, "A Simplified Cash Method of Accounting for Small Business," *Tax Notes*, February 13, 2012.

⁹ President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Nov. 2005; Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax Systems for the 21st Century," Dec. 2007; President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010; Nina E. Olson, "How Tax Complexity Hinders Small Business: The Impact on Job Creation and Economic Growth," (testimony of the national taxpayer advocate before the House Committee on Small Business), Apr. 13, 2011; and Testimony of Rick Endres, President, The Washington Network, Inc., before the U.S. House of Representatives House Committee on Small Business, April 9, 2014.



Source: Donald DeLuca, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance of Small Businesses," presented at 2007 National Tax Association meetings, Columbus, Ohio, November 2007. Table 9.

Overly aggressive tax planning may not help corporations in the long run. Since aggressive tax avoidance by multinationals has become front-page news, any firm's CFO must be concerned about the effect of the tax planning on the firm's reputation with its own customers. This is especially true for a company that sells consumer products and has a valuable brand name.

In light of rising economic populism, it is also clear that the corporate sector must be collectively concerned about the impression it makes on the voting public. If anti-corporate sentiment grows and multinationals are increasingly viewed as not paying their fair share, it will be more difficult for both Democrat and Republican lawmakers to support any business tax reform, much less any business tax cuts, despite the plain fact that the need for corporate tax reform is growing.

Not too many years ago, international tax policy was dominated by a select group of technical experts and their clients whose goal was to promote multinational competitiveness and avoid double taxation. That has all changed now. Like it or not, the mainstream press, the public, and elected politicians are major influences on international tax policy. As a result, the focus of policy is on raising revenue and preventing double nontaxation.

In this environment, business groups could do themselves a favor by dropping their natural inclination to dismiss all proposed anti-base-erosion measures as misgivings of the misinformed. Even if businesses prevailed in the next round of international tax reform and managed to keep

their taxes low, their public relations problems would remain. Uncertainty and the threat of an even larger backlash would hang like a dark cloud over any short-term gains. Instead of swimming against the tide of public opinion, they should consider throwing their support behind loophole closing on the condition that any estimated revenue gains be earmarked for expansion of noncontroversial forms of business tax relief, such as cutting the corporate tax rate or increasing the research credit.

Economics of benefits of bipartisanship and fiscal responsibility. It is well understood by both business and the economics profession that uncertainty is a major impediment to business investment. Given that increasing business investment is a major policy goal, it is unfortunate that reducing uncertainty does not receive more attention in Washington D.C. In fact, political battles inside the Beltway often contribute to uncertainty.

When it comes to corporate taxation, we don't need a seesaw battle between the political left and the political right. The resulting policy uncertainty only diminishes business investment. Liberals must recognize it is not 1965 anymore. Sooner or later they will need to consider a radical overhaul of business taxation that includes enormous and challenging increases on other revenue sources to make for the lost corporate revenue. Conservatives must recognize that corporate rates cuts they tout have to be paid for on a permanent basis without gimmicks or overly optimistic assumptions about growth effects in dynamic scoring. Aggressive budgeting not only spooks the bond markets, it greatly dilutes the positive effects of any tax cuts because there is high probability those cuts will be rescinded when rosy budget scenarios are not realized.¹⁰ Supply-side theory emphasizes the rationality of the private sector and the need for permanent tax cuts. The private sector will not be fooled by accounting maneuvers and magic asterisks.

For the economy's sake, at all points in the process of developing tax reform alternatives, our leaders should be emphasizing the common ground between the two parties. This helps business plan for the future. When the parties aggressively push their own agendas, all that business can count on is that there is likely to be major change after the next election.

* * *

Thank you for the opportunity to discuss these important issues. I am happy to answer any questions that the committee may have.

¹⁰ For example, it might be the case that the failure to-date of the tax cuts in Kansas to produce large economic growth is not any shortcoming of supply-side economics per se but of business's assessment that the cuts would only be temporary if Governor Brownback lost the election (which he did not) or if significant projected budget shortfalls resulted (which they did). See Martin A. Sullivan, "Were Kansas Tax Cuts True Supply-Side Policy?" *State Tax Notes*, Feb. 1, 2016, p. 323.

Chairman BOUSTANY. I thank you all for your excellent testimony, and we will now proceed with a question and answer session, and I will start.

I have long felt that as a country, we don't have a coherent foreign economic policy which looks at the strength of our own economy, domestically, and promotes growth here, and it also promotes top-of-the-line competitiveness abroad to put us in a strong economic position to lead. I just fundamentally believe that. And I have become increasingly concerned, over the last several years, that what we have as a Tax Code is a major contributor to that, and we have to start with fundamental tax reform.

But—and I think all of you know, based on some of the work and things that I have written lately in a lot of my statement, I am really concerned about the competitive climate American companies here are facing, as well as abroad, and how this affects growth in the United States. And the recent global developments are very disturbing in my mind because if you look at OECD BEPS, State aid coming out of Europe, these investigations, they are clearly targeting American job creators overseas seeking to grab tax profits retroactively, increase the cost of doing business abroad. And our inertia in this, and Congress' inability or unwillingness to act rather than just simply talk about this is a problem.

At home, I mean—and frankly, because of the inertia, the administration took it upon itself to issue the recent 385 regulations, and I think these are punitive. They are actually, they are hurting American companies, and it is not just American companies that are large and trying to do business abroad, but it is also hurting companies and businesses here in the United States, making the United States less competitive, and a less attractive place to do business and invest.

And I think, you know, yes, you guys have been in front of the committee for quite a while, numerous testimony—episodes of testimony. We have been just beating this dead horse. We have got to act and—but I wanted to at least have a clarifying moment, and this serves as that clarifying moment. In fact, my friend, the ranking Member and I joked a little bit about this earlier to the extent that we could probably have a unanimous consent agreement here let's just go reform the Tax Code and be done with it, but the fact is—you are there, right?

Mr. NEAL. Yeah.

Chairman BOUSTANY. There you go.

So what—I mean, in light of what I just said about competitiveness and need for a coherent foreign economic policy for the United States to put us in a very competitive position, which encompasses not only growth here at home, but competitiveness abroad, would each of you just briefly comment on that in the time I have got left here?

Mr. HODGE. Well, Mr. Chairman, I think we have reached a point in which either we define our tax base or the Europeans will. And right now—

Chairman BOUSTANY. And they are doing it.

Mr. HODGE [continuing]. Our major competitors are defining our tax base, and as you mentioned, they are trying to plunder it, and I think that is a real danger, not only to the economy, but also

to the competitiveness of the United States. And the sooner that we move toward a competitive international tax system and lower the rate, as Mr. Sullivan has mentioned, as dramatically as possible, I would say around a 20—15 to 20 percent in Federal corporate tax rate, the better. And the sooner that we will stop the hemorrhaging of profits abroad, we will stop the inversions, we will stop the plundering of our tax base, but it is up to us and we need to move quickly because they are not waiting for us.

Chairman BOUSTANY. Thank you. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I think, you know, we need to recognize that. We have to stop playing defense. It is not a matter of just keeping the headquarters here or keeping our tax base or—we need to aggressively make this a place where people want to be, so that we attract global companies from abroad that are highly successful, and that we increase the pace of economic growth. And I think the challenge, frankly, is that when we did the Tax Reform Act in 1986, it began in the late 1970s with people like Dick Gephardt and Bill Bradley saying the Tax Code is hurting the average American. It is harming the economy, so that Joe, you know, Handyman is not getting what he should.

We need the public education that says on a bipartisan basis, a better Tax Code contributes to a better standard of living in the United States, and we want to go get that for Americans. And if we just look we are playing defense to hold on to things for big corporations, I don't think we are going to make the sale.

Chairman BOUSTANY. Thank you. Dr. Foster.

Mr. FOSTER. Thank you, Mr. Chairman. One way to summarize a component of Dr. Sullivan's testimony is if you treat capital poorly, it is going to leave. Right now the Europeans are treating capital poorly. They are going to suffer a penalty for that. We need to treat capital better. We need to encourage it to come to this country.

After the 1986 Tax Reform Act, the United States was the leader in tax policy worldwide. We, then, basically sat on our hands for three decades. We made a few changes at the margins, but didn't do very much. The rest of the world kept changing. They took the lead that we started with and kept doing it, and they continue to do it today with further rate reductions and so forth.

As Dr. Holtz-Eakin said, we cannot play defense on this. We are already so far behind. It is more than just playing catch-up. If we have want to lead, if we want our economy to grow at faster than the 2 percent that Mr. Neal mentioned, we have to make this a place capital wants to come to and a place where we allocate capital wisely. So it is not just about making it a friendly place, but making it a rational place. We are not picking winners and losers. We are going to say we are going to have a neutral Tax Code, and we can all argue a little bit out on the margins what that means, but we understand the basic concept.

We don't want to pick winners and losers. We are not going to do it through the Tax Code. We will let the markets figure out where the capital can go, but we want capital to understand, it is welcome here.

Chairman BOUSTANY. Dr. Sullivan, you want to comment or—

Mr. SULLIVAN. I would just add that I think the other panelists are absolutely correct. We want the United States to be a place that attracts capital, but we also have to be realistic about two impediments. Dr. Holtz-Eakin mentioned educating the American public. Look at what is going on now in this current election. Look at the economic populism. If anything, the American public will be less tolerant of business tax cuts now than they have ever been before, so we are actually moving in the wrong direction in that—unfortunately, in that dimension.

And we have to think about the appearances of profit shifting, of tax shelters that are caught—whether they are just or unjust, how they are affecting the public's attitude towards business tax reduction. And the other thing we have to be very concerned about, and realistic about, is our budget deficits, which are going to be growing over the next decade. So it is one thing to want to lower the corporate tax rate. The hard part, of course, is finding out—is making the tough choices and finding the revenue to pay for that.

Chairman BOUSTANY. Thank you. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. To your point about the amount of time we have spent on this. I feel like I went to high school with all you guys. This is when the conversation started. But I also think it is a mindset that the four of you, given your institutional memories, would reinforce, and that is, Congress is made up more and more today of crusaders as opposed to legislators. I mean, the inability to hear what anybody else has to say about something that might work at any given time.

So the ideology creates the intransigence. And so Dave Camp puts out a model, and that afternoon, 52 Members of his own side torpedo the model. You know, there was at least a time where we would have taken a look at that and said, well, maybe we can shape that part of it that they object to and that they might be more receptive to that down the road. But it is instant opposition. And we find ourselves back to the impasse on Tax Code where we, once again, all agree with the nature of the problem but none of us necessarily agree with the nature of what we need to do on the solution side.

But let me speak to a moment on the issue of dynamic scoring. Really it was Dick Armey earlier in the 1990s who kind of hatched the idea in front of the Congress about dynamic scoring. One of the problems with dynamic scoring is it is always about tax cuts, where we find, again, the intransigence of trying to do a major highway bill.

And I would submit that the way that the highway bill was done at the end of the session, not something that we ought to be crowing about, pretty poor way to do infrastructure. But at the same time, I have been pushing the idea, what about if we are going to exempt the notion of dynamic scoring as it relates to tax relief, what about the idea of using dynamic scoring for some investment in spending on long-held needs the America.

And I would like the four of you to maybe speak to that directly, and then I am going to get around to the effective tax rate, because I think that bears consideration as well. So we can start from the—Mr. Holtz-Eakin, and move to the other side.

Mr. HOLTZ-EAKIN. As you know, I am capable of going on at length about dynamic scoring. I will spare you.

Mr. NEAL. Well, I didn't ask your favorite question today. I rehearsed it long and hard, but I didn't ask you because I knew what your answer was going to be.

Mr. HOLTZ-EAKIN. Because tax cuts don't pay for themselves, and I knew you were going to ask that. You always ask me that.

So I recently wrote a paper with Michael Mandel at Progressive Policy Institute on Dynamic Scoring of Infrastructure Spending, and there is no reason why dynamic scoring, which is simply good policy analysis, should apply to just one side of the budget. There are the usual implementation problems on the spending side as they are on the tax side, but I think it is something that has merit, and that certainly ought to be considered. And if you are going to have chairmen who have the power to say this is an economically significant piece of legislation, it should be dynamically scored, that should apply there as well.

Mr. NEAL. Dr. Foster.

Mr. FOSTER. Well, I think the first thing one has to note is, we talk about dynamic scoring and analysis, I have testified on it many times and studied it at great length, but the reality is we are in a very preliminary stage of understanding how to do dynamic analysis of tax policy. The Tax Foundation model is the state of the art, and they are in the process of learning how to do it.

That said, there is no reason why the full range of policies—once the economic science can support the analysis, there is no reason for the full range of Federal policy not to be subject to that kind of analysis. When you are looking at legislation, if there is something a model can tell you about its economic consequences, you should have that information.

Mr. NEAL. Mr. Hodge.

Mr. HODGE. Well, as you know, Mr. Neal, the Tax Foundation does have a dynamic tax model. And one of the lessons that I try to teach people, and I do a lecture on it, we actually do public and private demonstrations, live demonstrations of the model so that people can see how it works. We pull back the curtain so that there is—it is not a black box. Well, actually, we can do—we would be delighted to do one here if you would like.

But one of the things I try to point out to people is that the important element, or the important reason why you want to do dynamic scoring is because every tax change affects the economy differently. And what dynamic scoring does is it gives you an opportunity to understand the nuance differences between them.

For instance, we took five different tax cuts that all had the same score of about \$40 billion a year on a static basis, but doing it dynamically, you understand that a child tax credit has no impact on economic growth, but moving to full expensing actually has a substantially positive impact on our economic growth and can almost pay for itself over time. You want to understand those differences.

We have also been responsive to folks who say, Well, you ought to do spending as well. And we are in the process of building out our tax model to what is known as a general equilibrium model so we can model the macroeconomic effects of spending as well, and

we hope to have that portion of the model finished by the end of the year.

Mr. NEAL. Would you let Mr. Sullivan answer the question as well?

Mr. HODGE. My apologies for—

Mr. NEAL. No, that is fine.

Mr. SULLIVAN. Well, I would agree with Scott that the models are very good for educating Members on which policies some—you know, there is a whole range of economic policies, tax policies, some are better than others.

But I think there are biases in the models. And it is not that the modelers are biased, but models that you can produce wide ranges of estimates. You can't emphasize enough the uncertainty. I could take you into a library and show you shelves of books that support high elasticity with lots of economic growth, and I can take you to another shelf of books that show you the exact opposite. So the uncertainty factor, I think, can't be emphasized enough.

Chairman BOUSTANY. Mr. Hodge, you want to make—or Dr. Hodge, you want to make another comment?

Mr. HODGE. Yeah. I want to point out that while there are differences among the models, they are all—they all tend to point in the same direction. So that our model, the JCT's model, you know, John Diamond's model at Rice University, all tend to point in the same direction, so they are not giving you competing estimates. They are all—they may be in a range, but if they all say that a policy promotes growth, it will promote growth. If they all say it has negative impact on growth, you can be sure of that. They may be a range, but at least you will have the confidence that all of these models are saying roughly the same thing.

Chairman BOUSTANY. Thank you. Dr. Holtz-Eakin, briefly.

Mr. HOLTZ-EAKIN. Real briefly, because I have said this to this group before. There is no more uncertainty in dynamic scoring than static scoring. And I can tell you all the terrible stories of my time in CBO scoring terrorism risk insurance, or death benefits for those killed in Iraq prior to the invasion, those things are fundamentally uncertain. There is nothing about this that should be considered different.

Chairman BOUSTANY. Thank you. Mr. Reichert.

Mr. REICHERT. Thank you, Mr. Chairman. So I really like the way, Dr. Foster, that you went into, you know, some language that people really understand, because you are talking to an old cop here. I am not a tax attorney or a CPA. I am just fortunate enough to be on this committee and learn from you and all these other smart people here.

So you know, I think it is good that we put this in language where the average person can understand this and figure it out, because they do know, really, deep down what we need, and that is to simplify the Tax Code, right. They all feel, my constituents feel that—and I feel, over my career, that I have been working for the Tax Code. The Tax Code certainly is not working for me, and I think we need to turn that around so the Tax Code works for America, works for American workers, and American companies, and I think you have shared some ideas here that—and hopefully,

we will get a chance to read the book coming out, Mr. Hodge, and get some—and get some further ideas.

But you know, the whole—the whole idea of businesses—more businesses, growing businesses can make more stuff, to sell more stuff, to buy more stuff, to hire more people to make more stuff, people get, and I get that. What they don't get are terms like repatriation, inversion, innovation box, you know, dynamic scoring, none of that makes sense.

Now, I have learned those, about those things over the past few years being on this committee, but if you had told me years ago as a cop driving around in my patrol car that I would have been going through the Tax Code line by line in my career some time, I would have shot myself in the foot, but I am happy to be here today.

So I mean, it is complicated, and you all know that as well. Look how hard this has been for us to get to a point, you know, where we actually—I mean, we had this conversation yesterday in a hearing where we, as a panel, really need to come together, and this has got to be a bipartisan effort, like Dr. Sullivan has mentioned. Otherwise, it doesn't mean anything.

Certainty is one of the things I hear back in my district all the time. If my business had certainty, if my family had certainty, and I could make these decisions and we can move forward and be productive and be, you know, optimistic about the future.

So there is some things, too, that, you know, are occurring that are kind of out of Congress' hand, and you mentioned the competitiveness issue of the U.S. system and how, you know, and sort of following up on Dr. Boustany's, the chairman's comments, and encouraging capital in the U.S., I am curious what your thoughts are on the impact of some of the administration's recent decisions, especially the 385 guidance. And maybe, Dr. Holtz-Eakin, you can comment on that?

Mr. HOLTZ-EAKIN. I think what the administration has done under Section 385 might best be characterized as desperate, but it is certainly not good tax policy, and is, in the long run, quite counterproductive. Their rulemaking has been predicated on the notion that they are going to stop deals that have been entered into in mergers and acquisitions. And if I am a foreign investor looking to locate someplace, the last place I want to go is a place where the rules change in midstream or after the fact. That is not good policy-making. And, you know, they can decide to defend why they did it, but I think it is a damaging step from the point of view of high quality tax policy.

Mr. REICHERT. So your point is it is the uncertainty issue again and—

Mr. HOLTZ-EAKIN. Or worse. They are certain that we are going to get them once they get here. That is not a good message to send.

Mr. REICHERT. Yeah. Mr. Foster.

Mr. FOSTER. Thank you, sir. I think the—something to keep in mind, at the U.S. Chamber, we—when this regulation came out, we quickly reached out to our Members to ask them what does this mean for you? Weeks and weeks later, they are still going through the process of trying to figure out what it means to them. These are the smartest people in the corporate tax world, and as you

know, there is a lot of smart people in that world, and every day there is another, oh, my gosh, look what that does. Another transaction, another normal business relationship suddenly is exposed. Another ownership pattern that is perfectly normal, it has nothing to do with the kinds of loopholes or behaviors that one might associate with bad behavior, perfectly normal transactions and arrangements are now subject and questioned.

The administration wants to move very quickly to finalize this regulation, as we understand. Well, they need to understand it will be many, many weeks before the people who are subject to this regulation know what it means, and many weeks more before they can formulate any kind of comment on what it would mean, and perhaps there are actually a few things that the wizards at the Treasury Department haven't quite thought of yet.

Mr. REICHERT. Okay. I yield back. Thank you, Mr. Chairman. Chairman BOUSTANY. I thank the gentleman.

Mr. Doggett, you are recognized.

Mr. DOGGETT. Mr. Chairman, and thank you, Members. Thanks to each of our witnesses for your comments.

Mr. Hodge, if I understand, you believe, on the business side, we should simplify our Code by permitting businesses to expense immediately all assets that they might acquire instead of depreciating them, regardless of the amount, or the useable life of the asset?

Mr. HODGE. That is correct.

Mr. DOGGETT. And on the individual side, you believe that we should replace deductions with a larger standard deduction but eliminate itemized deductions?

Mr. HODGE. I think that would greatly simplify the Code. Yes, definitely.

Mr. DOGGETT. So you oppose the home mortgage interest deduction?

Mr. HODGE. We have looked at the economics of it. Economists are on different sides of that issue.

Mr. DOGGETT. What side are you on?

Mr. HODGE. I would trade that off for a lower rate. I think you would have better economic performance.

Mr. DOGGETT. Is the same true of charitable deductions?

Mr. HODGE. It would, yes.

Mr. DOGGETT. And is the same true of a deduction for State and local income and sales tax?

Mr. HODGE. That one especially, I think, should be eliminated for lower rates immediately.

Mr. DOGGETT. Thank you. Dr. Sullivan, directing your attention, especially to one of your concluding realistic recommendations. If I understand it, if your favored approach of substituting a value-added tax for the corporate tax doesn't get adopted anytime soon, you have emphasized the importance of assuring that any changes in corporate rates are paid for on a permanent basis without gimmicks or overly optimistic assumptions.

So you believe, to use the term we are most familiar with, that any changes in our corporate tax structure, be they limited to one type of business entity, or one type of business transaction, ought to be revenue neutral?

Mr. SULLIVAN. Yes.

Mr. DOGGETT. And Dr. Holtz-Eakin, do you believe the same that changes in corporate taxes should be revenue neutral?

Mr. HOLTZ-EAKIN. No. I think they should be budget neutral, so you could do the offsets on the spending side. I think that would actually be quite desirable.

Mr. DOGGETT. You would do it on the spending side, and I am sure I know the position of our other witnesses on that. With reference to how one achieves revenue neutrality, Mr. Camp was not richly rewarded for being willing to say how, but he did suggest on—as part of his proposal, tax pay-fors that included changing the way advertising expenses are charged, changing accelerated depreciation, a problem, I guess, Mr. Hodge would eliminate for us, and repealing last-in/first-out inventory. Are those changes that you think are pay-fors we should be adopting, Mr. Sullivan? Dr. Sullivan?

Mr. SULLIVAN. I think that accelerated depreciation is something that does promote economic growth. If we moved towards expensing, that would help promote economic growth. So we—I think one thing we have learned from the recent debate on tax reform and from the dynamic scoring coming out of the joint committee is that we need lower rates that helps promote economic growth. Expensing helps promote economic growth.

And so once you take out accelerated depreciation as a revenue raiser, you are really running out of base broadeners inside the corporate tax. So that is why we need to look outside the corporate tax for additional revenues. And one—I think one possibility that is getting a lot of attention is looking at raising the taxes on capital gains and dividends in order to pay for a lower corporate rate because that would maintain the progressivity of the tax system.

Mr. DOGGETT. You also refer, perhaps in somewhat more neutral terms than the chairman, to the OECD-based erosion, the BEPS project. And again, from a realistic standpoint that substantial value creation, sales and other indicators in a country is becoming increasingly the worldwide standard among advanced economies. Is that your view, and what is your perspective on the base erosion project?

Mr. SULLIVAN. Well, I think what we are seeing, the base—the fundamental—you know, it is very complicated, thousands of pages long. But I think the two things that you are seeing from the base erosion, the BEPS project is, one, we want to get rid of cash box, tax haven companies where there is no economic activity, but a lot of profits toward it, and I think the BEPS project is going to make a lot of progress along those lines.

Mr. DOGGETT. You think it is positive?

Mr. SULLIVAN. Yes, because of—that, in the long run, we—it is not helping U.S. businesses to have the terrible appearance of not—of stateless income and—

Mr. DOGGETT. Stateless income.

Mr. SULLIVAN [continuing]. Abusive tax planning.

Mr. DOGGETT. Thank you. I certainly agree.

Chairman BOUSTANY. We thank the gentleman. Mr. Kelly.

Mr. KELLY. Thank you, Chairman. Thank you all for being here. But I do think this is kind of recurring, right. We just keep talking about this, and I don't know if it was the sheriff that said it was

somebody that said there was an old saying you keep shooting yourself in the foot and wonder why you are limping.

Look, we have been talking about this for so long. Maybe some of you that can go back in time, in 1986, it was really tax reform. What was the magic then? What was so obvious then that is so clouded now?

Mr. HOLTZ-EAKIN. As I said earlier, the 1986 reform started in the late 1970s with people on both sides of the aisle, the Dick Gephardt, Bill Bradleys, the Democratic side, the Alvin Ross, Jack Kemps on the Republican side and others, Art Laffers, talking about the damaging impact of the U.S. tax system and how this was something that was hurting average Americans.

It took a decade of public education, and then it took a sitting President to run for re-election on the promise of doing tax reform, as Ronald Reagan did, and it took probably three or four legislative deaths and a pretty good beer-infused break in an Irish pub to get it done. It is really hard, but I think the essential piece there was the bipartisan nature. I want to emphasize that. I think Mr. Sullivan is right about that. And the public education.

Tax reform for the elites, businesses getting something for them that doesn't appear to be connected to the average American, is not going to fly.

Mr. KELLY. Okay. So looking at Mr. Neal, the idea is to get more Irish legislators. Is that right?

Mr. HOLTZ-EAKIN. We know that it is not just going to the pub, because they tried that.

Chairman BOUSTANY. It is really about the beer.

Mr. NEAL. Sure, we got that part of it down pretty good.

Mr. KELLY. Mr. Foster. Anybody, because this is—

Mr. FOSTER. Yes, sir.

Mr. KELLY [continuing]. So reoccurring that—

Mr. FOSTER. What Doug Holtz-Eakin said about the history is terribly important. I date the 1986 Act's birth with a hearing of the Joint Economic Committee chaired by then-Senator Lloyd Bentsen of Texas, who began an exploration of the question of the capital gains tax, and it was that discussion which then led to legislation, which then led to further discussion and so forth, culminating 8 years later in the 1986 Tax Reform Act, which was, in fact, a bipartisan process.

One of the interesting aspects of that is they—the proponents on both sides that Doug mentioned, had to still live down to an essential. That is what I tried to do in my testimony. What is comprehensive tax reform about, and as I described it, it is more businesses doing more business. They had to still live down to lower rates, a broader base. It was something everyone could understand. And as long as you adhered to that mantra and the product reflected that, you were successful, and that was something that both sides could agree on. It is still the correct mantra.

Mr. KELLY. Let me just ask it because we are going to run out of time here, but you know, if this was an athletic team or if this were a business, and you had an opportunity to look at everybody else that you compete against. I mean, really a deep dive into what it is that is allowing them to capture market, it would be hard to be sitting here today and saying we still don't quite understand

why these people are leaving the United States. They just must be un-American or selfish or something.

Do you remember the Pogo comic strip in the 1950s? Another Irishman, a guy named Walt Kelly, Pogo said we have met the enemy, he is us. But I look at you all, and you all can go real deep into—listen, I am just a guy that tried to find the best people to do the job and then stay out of their way and let them do it.

I am not like Mr. Renacci who understands taxes or loves taxes. I never understood them. I never loved paying them, but I did it anyways. The purpose of you being here today, though, is to, again, reiterate, this is like Captain Obvious, we are losing at the global level, and we can look around us about what everybody else is doing to capture our markets, and we are sitting here thinking what would it take for us to wake up?

And so the question about 1986 was, a House working with the Senate working with the White House where everybody had the same goal, and that was to take advantage of all the things that we have, one-fifth to the world's fresh water, an ability to feed ourselves without having to rely on anybody else, more sources of energy than anybody in the world. We could build geopolitical relationships that would end some of this craziness that is going on, and we are sitting here and still trying to figure out what is the problem?

I mean, isn't it so obvious? You guys must get to the point where you feel like you are hitting yourself in the head with a hammer, and the only reason you do it is because when you stop, it makes you feel better, but this is just insane.

So I can't tell you how much I appreciate you being here. You don't need a lecture from me. Listen, you guys are deeper than the Pacific Ocean when it comes to tax policy. I am just a guy that is looking at it and thinking, I really do know what the problem is. It is people like us sitting here not able to get along with other people like us serving the American people and their best needs. It is pretty obvious.

No response from everybody. I know you all are shaking your head. Yeah. Okay. All right. We are all together. Let's go. Let's go get them.

Chairman BOUSTANY. Mr. Renacci. Follow that.

Mr. RENACCI. Thank you, Mr. Chairman. Well, first, I am going to correct my colleague, Mr. Kelly. It is not that I like taxes. I had to live with taxes for 30 years, and because of that, I learned the system. And I have to say that I even went all the way back. I was thinking, I actually was involved in my first CPA firm prior to the 1985 and 1986 changes, so I got to see prior and I got to see the changes and had to live through all that as well.

But I am going to ask you all some yes or no questions because I want to run through some things, and then I have got some questions that might take a little longer. But first question. I think it is important to understand who bears the burden of our high corporate rate. Isn't it true that the burden of the corporate income tax does not ultimately fall on corporations but, rather, on the people, the customers, the workers, the investors?

And the reason I ask that question, I say that to people, they look at me, they don't understand what I am saying. But ulti-

mately, I try and tell them, a business will not be in business if it doesn't pass on its corporate tax. So would you all agree, I take it, yes or no, across the panel?

Mr. Eakin.

Mr. HOLTZ-EAKIN. Yes.

Mr. FOSTER. Yes.

Mr. HODGE. Yes.

Mr. SULLIVAN. Yes and then some.

Mr. RENACCI. That was easy. It is clear that we have an outdated and anticompetitive Tax Code. And it is also clear how harmful corporate income taxes are to economic growth. Would moving to a consumption-based tax system be more pro-growth than a reform that sticks with the traditional income-based system?

Mr. HOLTZ-EAKIN. Yes.

Mr. FOSTER. Yes.

Mr. HODGE. Yes.

Mr. SULLIVAN. Yes.

Mr. RENACCI. Wow. Okay. Next question. Would a zero corporate income tax with a single-digit consumption tax give us the most competitive tax system in the world?

Mr. HOLTZ-EAKIN. Yes.

Mr. FOSTER. That would depend on everything else going on. That's too general a question.

Mr. RENACCI. That is all right. I don't expect all yeses.

Mr. HODGE. Yes.

Mr. SULLIVAN. Yes, if it is paid for.

Mr. RENACCI. Okay. Over the last 3 decades, the average marginal corporate income tax rate among OECD countries has fallen from 48 percent to under 25 percent, and since 2000, we are one of only three of the 34 OECD countries that has not cut their corporate tax rate. Given that other OECD countries have a national level consumption tax, would other OECD countries have been able to cut their corporate income tax rates without increasing their VAT, value added tax, or the GST, goods and services tax? So would they have been able to cut their taxes without increasing the VAT or the GST tax?

Mr. HODGE. Some have and some haven't. Canada, for instance, has cut their corporate tax rate without raising their GST. Some other countries, I think the U.K. may have ticked it up a little bit.

Mr. RENACCI. How did they pay for it? I guess that is why I am asking the question.

Mr. HODGE. Yeah, Marty?

Mr. SULLIVAN. They raised a lot of other taxes. They have a bank tax. They reduced their depreciation allowances. They have a carbon tax. So they looked at other sources of revenue to pay for what is going to be a 17 percent rate.

Mr. HODGE. But the Canadians, on the other hand, I have seen their corporate tax revenue's fairly stable, I would say.

Mr. SULLIVAN. Yeah.

Mr. HODGE. And a lot of it is because of profit shifting out of the United States to Canada. So they have been the beneficiary of our high tax rate by lowering theirs.

Mr. RENACCI. Okay. I got to keep moving. Would raising the standard deduction and eliminating most itemized deductions pro-

vide a simple tax system for individuals without discouraging work and investment?

Mr. HODGE. It depends.

Mr. HOLTZ-EAKIN. Yeah. Depends how you do it.

Mr. SULLIVAN. Yeah.

Mr. RENACCI. Okay. Everybody is kind of shaking their head. Depends, yes. I mean, again, I am just trying to say—

Mr. SULLIVAN. It would certainly simplify it.

Mr. RENACCI [continuing]. Most people say if we simplify it—

Mr. HODGE. I think that is one of the entries in our book, and you will know in 2 weeks when we release it.

Mr. HOLTZ-EAKIN. So the mantra is low rate, broad base. You are keeping the same narrow base in a different form, or the raise.

Mr. RENACCI. Okay. So let's go to this. So has the model of an entity-based tax with fully expensing been adopted by any other OECD country?

Mr. HODGE. Say that again.

Mr. RENACCI. A model of an entity-based tax with fully expensing been adopted by any OECD country?

Mr. HOLTZ-EAKIN. I don't think so.

Mr. FOSTER. I don't think so.

Mr. HODGE. I don't think so.

Mr. SULLIVAN. I don't think so, no.

Mr. RENACCI. The answer is no. I just wanted to see if you would agree to it.

Mr. HODGE. This is a test.

Mr. RENACCI. So let me ask the question about fully expensing. I don't have a lot of time left on fully expensing. Because, look, I am a big believer in fully expensing, but here is the downside and this is from living in the real world. I always use Mr. Kelly as my example. He has a car dealership, I have a car dealership. I have cash, he has no cash. I can buy my dealership, he can't buy the dealership. He has to lease it, I can buy. I am going to fully expense my building. I am not going to pay any taxes. He is going to lease his building. He is going to pay taxes.

Fully expensing is good in the sense if you have cash. It hurts the guy who doesn't have cash. That is coming from a guy who started his business with no cash. Tell me if you agree or disagree with that. This is when you stump the economists.

Mr. FOSTER. I think I mostly disagree, because you leased it from a company that expensed it. So the savings from the leasing company expensing that building, then get passed through to you in a competitive market.

Mr. HODGE. Right.

Mr. RENACCI. But that is not the case, because I will pay—so I will give you a better example. And I know I am running out of time. I was in the industry. I was in the nursing home industry. I had 23 facilities. I had \$120 million in assets. I would have expensed those fully and I wouldn't have paid a dime of tax over 20 years. The guy who had the lease and had no cash, he would have been paying taxes. Somebody has to pay taxes in the fully expensing model. It is the guy who can't fully expense. And—

Mr. HOLTZ-EAKIN. That is right, because we want the people who are making the investment, even if it is the leasing company, to have the appropriate tax incentives.

Mr. RENACCI. So the—

Mr. HOLTZ-EAKIN. If you want a Tax Code designed for growth, you have to reward people generating growth. And the leasing company that builds the facility is doing it.

Mr. RENACCI. The only issue there is that Mr. Kelly, if he had 12 to 23 dealerships and I had 23, he could not be able to compete with me. We will leave it there. I know I am running out of time.

I yield back.

Chairman BOUSTANY. I thank the gentleman.

Mr. Reed.

Mr. REED. Well, thank you, Mr. Chairman, and thank you to the panel for kind of taking up my counterpoint to Mr. Renacci's point that we had that conversation not too long ago. So I appreciate those comments.

You know, we are talking a lot here today about business reform. I want to focus a little bit more maybe on the individual side too as we deal with this issue. Seems to be a broad agreement as where we need to go on the business side. But I want to really stand up for the folks back in my district, for example, Western New York, a rural district. I want to talk about the mom-and-pops. I want to talk about the individuals there that are struggling under this broken Tax Code.

So could any of you, as we deal with the goals of tax reform, as we deal with that, why do the individuals back in my district need tax reform today? Can you give me examples of what they are dealing with that maybe we need to highlight and be aware of as we go forward in tax reform?

Mr. Hodge, Mr. Sullivan. We will go with Mr. Sullivan.

Mr. SULLIVAN. I think the most important thing for small business and the easy—is simplification. All the data show that, you know, we all want simplification. Large businesses want simplification, individuals want simplification. But for small businesses, it is very expensive for them, and I think the best thing we could do for small business is tax simplification.

Mr. REED. Tax simplification. In order to achieve tax simplification for the small businesses or the individuals, where should the priority be focused? I mean, obviously, we are talking about raising the standard deduction, full expensing rather than keeping track of archaic depreciation schedules and everything else. Would you agree those are types of concepts we should be looking at in regards to individual and small business?

Mr. Eakin.

Mr. HOLTZ-EAKIN. I think those things are important. If you think about all the discussion of sort of base broadening on the corporate side, that is going to flow over to the passthrough entities who are, in the end, the moms-and-pops. If they are not worrying about a thousand special tax rules that deal with advertising and foreign sales and this and that, then they just have a nice simple base with low rates, cash accounting, it will be much easier for them to comply.

Mr. REED. And so going along those lines, and especially since a lot of folks down here down in D.C. are struggling with the handcuffs of revenue neutral, distributionally neutral and those types of conversations, how do you quantify that simplification for—like when I had a small business, I will tell you one of the things that frustrated me, when I dealt with my accountant, he would say, hey, Tom, I need you to find XYZ. All right, hold on. I got to stop everything I am doing. I have to go over here. Two weeks later, I get him the stuff. And the one time he said, oh, I forgot to tell you, I already had that information. I almost fired him on the spot. But that was a whole other situation.

But how do you quantify those hours that I spent in the basement looking for receipts for an accountant that were really it was just because he needed to comply with a complex Code? How do you quantify that? How do we do a better job of putting a number on that?

Mr. Hodge.

Mr. HODGE. Well, actually, I put a number on that in my testimony. New data has come out of Reginfo, it is out of OIRA, that calculates the time in which we comply with OIRA's paperwork. And they have an account of all the provisions of the Tax Code and how many hours that we take as a Nation to fill out those forms. It now adds up to \$409 billion a year.

Mr. REED. Amen. So in your experience dealing in, Mr. Holtz-Eakin, I know on the CBO side, and you guys dealing with joint tax, what has been your experience with joint tax and their score mechanisms and their rules on scoring? Have they been really good at quantifying the hundreds of billions of dollars in simplification benefit that we are going to be seeing?

Mr. HOLTZ-EAKIN. I can't speak for the joint committee, but the CBO is not good at that, doesn't even try.

Mr. REED. Thank you. I thought that was the case.

Mr. HODGE. And they are not in our economic model. Those are a side calculation from our macroeconomic model.

Mr. REED. And that is one of the things I think I have to wrestle with down here in Washington getting in my relatively short time here since 2010, is recognizing we need good policy to lead this conversation. And a lot of times we wrestle in D.C., in this Beltway bubble, with the handcuffs of the score as opposed to recognizing there are going to be these other consequences, positive consequences of tax reform that really should be brought into the debate and say, look, if you want to hit me with the score, let me just hit you with the commonsense. Let me just hit you with the benefit that I am going to hear from my residents of having a simpler, easier Code to deal with.

Is that a fair—is that a fair commonsense position to be able to take back to the district and say, this is why we are doing what we are doing?

Mr. HOLTZ-EAKIN. I think that is very important because in the end, scores are measures of the budget cost of policy.

Mr. REED. Right.

Mr. HOLTZ-EAKIN. They don't say anything about the benefits. You have to talk about the benefits because that is why you are doing it.

Mr. REED. And in 1986, did they do a good job? Is that a lesson we can learn from the 1986 reform? Did they do a good job of getting that out there?

Mr. HODGE. No.

Mr. FOSTER. No.

Mr. HOLTZ-EAKIN. No.

Mr. SULLIVAN. No.

Mr. REED. And how best can we get that information out there, other than through the organizations, various organizations you represent? How do we get that out there?

Mr. HOLTZ-EAKIN. I would argue it is you and all of your colleagues talking it at home. You know, for example, the point Mr. Sullivan made about the fact that our corporation income tax is increasingly hurting the wages of workers. They have a stake in getting this done, but they don't know it. And you are the best way to educate them of that.

Mr. REED. And I appreciate that and I exactly agree with you. So with that I yield back. Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman.

Mrs. Noem, you are recognized.

Mrs. NOEM. Mr. Sullivan, I found your testimony interesting. It says: As difficult as it has been in the past to enact stand-alone business tax cuts, the political environment now is probably less favorable to business tax relief than at any other time in living memory. And then you go into talking about kind of the political environment that we are living in this year. And it makes me think about other countries because they have, obviously, enacted business tax reform. Do they not have a political environment in these countries that has demonized businesses?

Mr. SULLIVAN. You know, it is a puzzling question, because on the one hand in other countries, the outrage over loopholes and profit shifting is even larger, like in the U.K.—

Mrs. NOEM. Right.

Mr. SULLIVAN [continuing]. It is a very, very big political issue. It is a front-burner issue. But on the other hand, the United Kingdom is able to have a 17 percent corporate tax rate.

Mrs. NOEM. Right. Right.

Mr. SULLIVAN. So it is a little bit puzzling. And the only thing, only suggestion I can make is, I think what the U.K., and I was just in Ireland, what they have done is they have really focused on cracking down on loopholes, on what their voters perceive as being abuse. So they get that out of the way and then they can focus on providing tax benefits that really make a difference. So clearing, it is not just a matter of broadening the base and lowering the rates.

Mrs. NOEM. Well, somebody said that earlier. I think it was Mr. Foster said the mantra is lower rates, broader base. And my question I wrote, does that still work? I mean, is that still enough?

Mr. FOSTER. Enough as a way of communicating, yes. I think people can understand that. You have to elaborate a little bit, have a discussion. Okay, what does broadening the base really mean, because people will get a little nervous when you talk about that. So you explain what it means and what it doesn't mean. But then it is an expression they can sort of get and then you just say it again.

And, oh, yeah, I remember, they were talking about that. That is a good concept.

It does work because it is something that people can understand. And you can elaborate on it just a little bit without getting into a lot of detail to reassure them that it doesn't mean that they are going to lose something they really care about.

Mrs. NOEM. Well, we use a lot of words when we talk about tax reform. We use simplicity, complexity, efficiency. Does growth still trump everything? Should we evaluate every single proposal that comes before this committee—and we have to keep our priorities straight. So should our number one priority be what gives you the most growth? You all agree with that?

Mr. HODGE. I believe absolutely.

Mr. FOSTER. Absolutely.

Mr. SULLIVAN. Absolutely.

Mr. HOLTZ-EAKIN. Absolutely. It is the paramount issue of the time.

Mrs. NOEM. Mr. Hodge, you did your modeling that you talked about. You have run many of the candidate's plans through your modeling. What is the one thing that surprised you the most from watching all of those different plans? And I would be interested in seeing you run some of the plans that people have on this committee that have sponsored running through your modeling process too.

What surprised you the most about the plans that you saw going through the modeling process, and what gave you great growth results when you ran them through the modeling process?

Mr. HODGE. Well, here is the political irony, that the tax changes that produce the most economic growth, and that is really cutting the cost of capital, are the least politically popular that you can imagine, cutting the corporate tax rate, moving to full expensing, integrating the corporate or business income tax system. Whereas the tax cuts or tax changes that are most popular, cutting individual tax rates, child tax credits, education credits, have the least impact on economic growth.

So that is the one challenge that you are going to have, is going out and trying to sell comprehensive tax reform in a way that is both politically popular but most pro-growth, and it is a real challenge.

In 1986, they put an emphasis on cutting individual tax rates and, actually, it pushed some of the economic burden over on businesses. And I don't think it had quite the growth effect it could have had had they not done some of that shifting.

Mrs. NOEM. Mr. Foster, you said in your testimony that tax reform should ensure industry-specific neutrality. What do you mean by that? Because there is no way to do tax reform—I don't agree that tax reform should be viewed through the lens of neutrality just because how much more complicated do we make the Tax Code in our provisions when we are constantly trying to keep everything equal for everybody? So tell me a little bit about what you mean. I know about not specifically hitting this industry hard because we hate this industry and the way it delivers energy or certain specifics, but what did you mean by putting that in your testimony?

Mr. FOSTER. What I meant is a specific form of neutrality. So we are not talking about revenue nor distributional. We are talking about economic neutrality. What we have today is an economy that is incredibly complicated and a Tax Code that is incredibly complicated. The two intermixing in sometimes very unfortunate ways. We have a system now where the Tax Code is dictating where businesses should invest and how they should operate. That is the non-neutral.

Mrs. NOEM. Okay.

Mr. FOSTER. What I am talking about is getting rid of all of that.

Mrs. NOEM. That is what I wanted to clarify. Is there anything new today that you guys have—I am out of time, I realize—but something from the last time you testified before this committee, is there something new that you have learned since then that you believe needs to be a part of our tax reform discussions? Or do you feel like you are just back here delivering the same message?

Mr. HODGE. Well, the estimates on the hourly time that it takes to comply with the Tax Code has been increased by 50 percent, according to the most recent estimates.

Mrs. NOEM. Okay.

Mr. HODGE. That is a shame. Time is the most precious thing that we have as human beings because we can't get it back. And the more time we comply with the Tax Code, I think is immoral.

Mrs. NOEM. Okay.

Mr. HODGE. And we can't get that time back. And I think you have an obligation to reduce the amount of time that we have complying with the tax system so that we can have more time for ourselves.

Mrs. NOEM. As a mom who is in Washington, D.C. away from her children every single week hoping we can do tax reform, which is the reason I came here, I totally understand what you are saying. I am tired of wasting time too.

I yield back, Mr. Chairman.

Chairman BOUSTANY. Thank you.

Gentlemen, we thank you for your testimony. It has been helpful. I hope we will now start the ball rolling on substance on tax reform. That is my hope. I think all of us share that goal. But we do thank you for being here to spur us on with the need for tax reform.

Please be advised that Members will have 2 weeks to submit written questions to be answered later in writing. Those questions and your answers will be made part of the formal record.

And with that, the subcommittee stands adjourned.

[Whereupon, at 3:35 p.m., the subcommittee was adjourned.]

Submissions for the Record



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June 8, 2016

Honorable Charles Boustany
Chairman
House Ways and Means Committee, Subcommittee on Tax Policy
1431 Longworth House Office Building
Washington, DC 20515

Honorable Richard Neal
Ranking Member
House Ways and Means Committee, Subcommittee on Tax Policy
341 Cannon House Office Building
Washington, DC 20515

Dear Chairman Boustany and Ranking Member Neal:

On behalf of AdvaMed and its member companies, we thank you for the opportunity to provide comments on our membership's perspectives on the need for tax reform. We appreciate the Subcommittee's interest in this topic and its recent hearing on the issue. We agree that tax reform is vital to stimulating economic growth in the United States, supporting business expansion and job creation, and will reduce the significant financial and regulatory burdens imposed by the current system. In particular, we believe that a repeal of the medical device tax and key policy changes to support pre-revenue companies would provide a significant boost to the medical technology sector and other knowledge-based industries that are vital to sustaining the American economy.

As you know, AdvaMed is the world's largest trade association representing the makers of medical technology—medical devices and diagnostics. Our members range from the largest to the smallest companies in the industry, with 70 percent having annual revenues of less than \$100 million. Collectively, our members account for 90 percent of medical technology sales in the U.S. and 40 percent of worldwide sales.

Medtech is one of the few American manufacturing industries that consistently maintain a positive balance of trade. Although the medical technology industry is global in scope, it has been a dynamic source of U.S. job creation, with employment expanding at a time when U.S. manufacturing employment generally was declining sharply. The jobs the industry creates are



good jobs, with wages that are almost 40 percent higher than the average pay for the economy as a whole and 22 percent higher even than average manufacturing wages.

Medical technology is an industry in which America leads the world. That leadership, however, is challenged as never before, and tax reform is an essential ingredient in ensuring that our industry continues to be a source of good jobs, economic growth and new treatments, diagnostics and cures in this century of the life sciences. Competitor nations have made developing jobs in our industry and other high, value-added knowledge-based industries like ours a priority, both in terms of tax benefits and in terms of other targeted public investments designed to place a priority on locally sourced products and to incentivize in-country development of medical technology research and manufacturing. With rapidly aging populations in the U.S. and world-wide, the growth of large markets of middle class people demanding high quality medical care in countries like China, India and Brazil, and the potential for innovative new treatments and cures in this century of the life sciences, the future of our industry is bright. But it is an open question whether this future will be made in America or somewhere else.

There are a number of danger signs suggesting that America's leadership is declining. The new normal is for companies to conduct first clinical trials and first product introduction outside the United States. This involves a significant transfer of expertise abroad and reduces the attractiveness of locating manufacturing and R&D in the United States. Other countries are eager to share in the high wages and high value added generated by medical technology and are making significant investments in developing home grown industries and encouraging multinationals to locate manufacturing and research locally. Venture capital flowing to U.S. medical device start-ups has declined sharply—a mark of low investor confidence in the future of the U.S. industry and an indication that the pipeline for new products to fuel industry growth will be less robust in the future. A study in 2011 by Pricewaterhouse Coopers showed U.S. leadership on each of five pillars of medical device innovation is eroding.¹

While the principles below were designed by AdvaMed based on the needs of the medical technology industry, we believe they are broadly applicable to all knowledge-based manufacturing industries—a key part of the high value added tradable sector, which is essential to America's future as a prosperous country where wages are high and prosperity is broadly shared.²

To create a level playing field with competitor nations and retain American leadership in medical technology, AdvaMed recommends:

- **Repealing the medical device excise tax.**
- **Lowering the overall corporate tax rate to levels comparable to or lower than other competitor nations.**

- **Establishing an “innovation box” to lower tax rates on profits earned from R&D and manufacturing based on that R&D, as well as providing general tax incentives for manufacturing.**
- **Providing research and development incentives comparable to or better than competitor nations.**
- **Enacting tax incentives to encourage investment in start-up companies that have no profits.**
- **Conforming the treatment of international earnings to that of competitor nations by adopting a territorial tax system.**

The medical device tax remains the number one threat to the long-term prospects for the industry. Imposing an excise tax on the industry is simply bad tax policy, and there is significant bipartisan support for a permanent repeal of this burdensome tax. Any conversation on tax reform for this industry has to start with leveling the playing field and eliminating this burdensome tax.

The medical device tax uniquely impacts the economic competitiveness of our industry, but it is important to note that the positive impact of medical technology on economic growth and competitiveness goes well beyond the jobs and economic activity associated with industry R&D and manufacturing. A recent study by the Milken Institute examined four diseases and a limited number of technologies used to treat those diseases. It found significant increases in labor force participation and productivity directly attributable to the technologies’ contribution to reducing the burden of illness. These increases in labor force participation and productivity, in turn, had expanded 2010 GDP by \$106 billion.³ Between 1980 and 2010, medical advancements helped add five years to U.S. life expectancy.⁴ However, more than half of AdvaMed’s member companies reduced R&D as the result of the medical device tax, and a similar proportion said that if the tax had continued they would be forced to make further or first-time reductions in R&D, with obvious implications for long-term competitiveness.⁵

With strong bipartisan support, Congress approved a two-year suspension of the device tax. Thanks to that suspension, medical technology companies are working to improve investment in R&D, restore employee benefits, and re-start delayed projects. It is crucial that Congress build upon the significant step on behalf of patients, researchers, employees and many others. As part of any large-scale tax reform effort, we urge Congress to take the next step of full repeal to protect American innovation.

America’s corporate tax structure is not the only source of America’s declining competitiveness in medical technology, but it is a key contributing factor. Today, America’s tax structure is uncompetitive, and it is especially so for medical technology. Medical technology companies, whether domiciled in the U.S. or abroad, pay an average effective tax rate of 31

percent for activities located and taxed in the U.S. and only 14 percent for activities located and taxed abroad.⁶ The medical device excise tax adds a heavy additional burden, raising total federal taxes paid by the industry by 29 percent.⁷ This increase of almost one-third raises the tax burden on the medical technology industry to a level that is surely one of the highest experienced by any American manufacturing sector. The high tax burden on U.S.-based activities also has a significant negative effect on industry decisions about where to locate existing and new manufacturing and R&D.

While repealing the medical device tax remains our top priority, AdvaMed also is focused on improving the tax environment for our early-stage, pre-revenue companies. These companies are at the cutting edge of new medical technology inventions and represent the "seed corn" of our industry's future. Enacting specific incentives into the tax code to support these firms is vital to leveling the playing field with other developed economies and encouraging companies to establish and grow in the United States. A more detailed white paper, providing an analysis of several international tax regimes comparable to the U.S. and laying out specific policy options for supporting new innovator companies through the tax code, is attached as an appendix to this letter. In total, our specific recommendations will help ensure that the tax code supports, rather than diminishes, American competitiveness in medical technology.

Once again, AdvaMed thanks the Subcommittee for its commitment to tax reform and for its willingness to consider our comments. For our industry, tax reform is an essential ingredient for our long-term competitiveness. We look forward to working with you as your discussions move forward. Please do not hesitate to contact us if we can provide additional information.

Sincerely,



Scott Whitaker

¹ PwC, "Medical Technology Innovation Scorecard: The Race for Global Leadership," January, 2011.

² Michael Spence and Sandrik Hlaszwayo, "the Evolving Structure of the American Economy and the Employment Challenge," Council on Foreign Relations, March, 2011. For the special importance of manufacturing in driving economic growth, see *The Competitiveness and Innovative Capacity of the United States*, prepared by the U.S. Department of Commerce in consultation with the National Economic Council, January, 2012.

³ Anusuya Chatterjee, Jaque King, Sindhu Kubendran, and Ross DeVol, *Health Savings: Medical Technology and the Burden of Disease*, July 2014.

⁴ National Center for Health Statistics. "Health, United States, 2012: With Special Feature on Emergency Care."

Hyattsville, MD. 2013.

⁵ "Impact of the Medical Device Tax."

⁶ Survey of AdvaMed member companies.

⁷ Ernst and Young, "Effect of the Medical Device Tax on the Federal Tax Liability of the Medical Device Industry," November 2012.

American Innovation at a Crossroads:

**Tax Policy to Encourage Knowledge-Based Industries in a
Global Economy**

DLA Piper
May 2016

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Executive Summary

The presumption of this paper is that America's economic future depends in large measure on its ability to compete in knowledge-based, high value added, innovative industries. These are the industries where the U.S. has a comparative advantage, and only by maintaining that advantage can we hope to prosper and retain high living standards in a global economy.

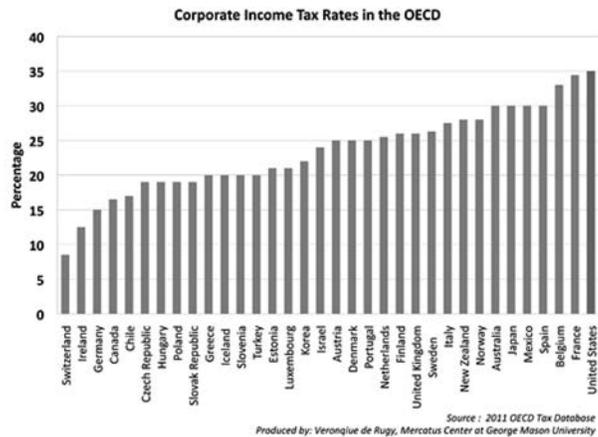
While America has immense historical capital in these industries, our historic advantages are eroding as other countries seek to develop their research and educational infrastructure, lure companies currently centered in the U.S. to locate much of their economic activity abroad, and provide incentives for home-grown companies to develop. Tax policy is a key incentive that can affect both location decisions and the likelihood of start-up companies flourishing.

However, the U.S. tax code, once considered a pace setter in encouraging innovative industries, is now considered obsolete and a significant drag on the U.S.'s ability to compete. The U.S. remains one of the few nations that continues to tax its companies on their worldwide incomes, and the U.S. corporate tax rate, 35%, once one of the lowest among industrialized nations, is now the highest of any nation in the OECD. The U.S. was the first country to establish a tax credit for research and development, but now has one of the least generous in the world. Numerous other countries have established special tax preferences or non-tax incentives to lure knowledge-based high value industries or help grow them domestically, while the U.S. has failed to institute comparable policies. Private capital has also followed the path of least resistance; recent data published by Thomson Reuters shows that the percent of global venture capital dollars invested in the U.S. has fallen to a near low of 54 percent in 2015, down from a high of 86 percent in 1997.

This paper discusses the major tax and non-tax incentives in foreign systems to attract and promote innovation and the need and possible means by which the United States can regain its role as the world's undisputed leader in the development and commercialization of new technologies. It is based on a presumption that the U.S.'s continued ability to nurture and compete for knowledge-based, high value industries is crucial to our economic future and that tax policy can make an important contribution to competitiveness.

The need for action by U.S. policymakers is urgent. While the U.S. Congress has debated tax reform for over a decade with no result, the European Union and the OECD through various means, including dramatic reductions in rates, the ongoing Base Erosion and Profit Shifting (BEPS) initiative, and an increased commitment to support innovative enterprises, have opened their doors to innovators.

The first factor is the very high U.S. corporate base tax rate compared to competitor nations.



The second tax factor that impacts U.S. competitiveness interacts with the first. The U.S. has a world-wide tax system that defers taxation until profits are brought back to the U.S. No other major economy has such a regime in place, and the combination of the U.S. treatment of foreign earnings and the high U.S. tax rate is a strong incentive for companies to shift economic activity abroad and a strong disincentive for companies to invest foreign earnings in the U.S.

While the high overall rate is a significant anti-competitive factor, reform of the base rate alone is not likely to bridge the competition gap. Even the most ambitious corporate tax reform proposals recently introduced in Congress would lower the tax rate only to about 25 percent, and this lowering would be coupled with elimination of tax preferences that may have a countervailing effect on effective tax rates. The medical technology industry, which may be typical of other knowledge-based, research-intensive manufacturing industries pays an average effective tax rate of 31 percent for activities located and taxed in the U.S. and 14 percent for activities located and taxed abroad (the U.S. figure does not include the impact of the medical device excise tax which has been suspended for the years 2016 and 2017).¹

A number of other countries have established special tax and non-tax incentives to attract and nurture innovative, knowledge-based industries, including advanced manufacturing industries. Knowledge-based manufacturing industries are special targets, as these industries create large numbers of well-paying jobs for both blue-collar and white collar workers. Adopting some version of these

¹ AdvaMed Member survey.

incentives in the U.S. could help make U.S. industries significantly more competitive and help compensate for what will likely be a substantially higher base corporate rate in the U.S., even under a reformed tax system. This paper reviews these incentives, with a special focus on patent or innovation boxes, and discusses how they might be adapted for the U.S.

Finally, except for potentially making the climate for innovative industries generally more favorable, most tax systems both in the U.S. and overseas do not address the needs of pre-revenue start-up companies, which are often the drivers of innovation, and, as they grow, a major source of job creation. Other countries use non-tax mechanisms, discussed in the following pages, to support these companies. Some are potentially adaptable to the U.S., but given the U.S. aversion to policies that pick “winner and losers,” a more general tax approach may be more appropriate for the U.S. The paper concludes with a discussion of some tax incentives that could support innovative start-up companies in the critical pre-revenue phase.

I. Disproportionately high U.S. corporate tax rates and the worldwide tax system put U.S. companies at a competitive disadvantage and drive jobs and economic activity away from the U.S.

The U.S. has one of the highest corporate income tax rates in the world at 35% and after state taxes are layered in, the tax rate could exceed 40%.² Not only does this provide companies ample business justification to locate profits in low-tax jurisdictions, it hurts U.S. competitiveness either through the higher prices companies must charge to recoup investments or the inability of companies to reinvest sufficient after-tax funds to grow their businesses.

The high corporate tax rate creates a competitive imbalance between U.S. companies and their foreign counterparts, which U.S. companies have responded to, in part, by locating activities abroad. Given the growing global nature of international commerce, customers and businesses have wide flexibility in choosing between competing companies and products, and are less tied to geographical constraints of yesteryear. In addition, with the expansion of the availability of information, customers and businesses are the most educated than they have ever been. This current business landscape puts a premium on pricing and innovation, both of which are hindered by a tax rate that can be almost three times as high as other developed nations.

The U.S.’s worldwide system has a particularly insidious effect in the context of disproportionately high U.S. base tax rates. Under the U.S. corporate income tax system, profits earned by a foreign subsidiary are not subject to current U.S. taxation. Instead, these profits are only subject to

² Some commentators have argued that the imbalance between U.S. and foreign tax systems is much less when the comparison is between effective tax rates, rather than statutory rates. The data cited above on the experience of medical technology companies shows a wide discrepancy between effective tax rates as well. A comparison of the effective tax rate on a hypothetical domestic manufacturing company based in the U.S. compared to a comparable company based abroad showed the U.S. to have the highest rate of nineteen companies examined, except for Japan, which subsequently significantly lowered its corporate tax rate (Grant Thornton, “International Taxation of Manufacturing: a Comparative Review.”)

U.S. tax when repatriated back to the U.S. Because money repatriated back to the U.S. would be subject to the 35 per cent U.S. corporate income tax rate, companies generally prefer to keep those profits offshore to invest in foreign acquisitions, to increase activities outside the U.S., or simply to hold on their books. According to reports, the cash holdings of U.S. multinationals nearly doubled between 2008 and 2013 to more than \$2.1 trillion dollars. Thus, the U.S. has the worst of both worlds. The high U.S. tax rate creates an incentive for companies to locate activities abroad, where taxes are lower, and when the foreign investments reap profits, the company faces a strong disincentive against investing those profits in research and development or job creation back home.³

II. Special Tax Incentives For Knowledge-Based Industries

A. Overview

Knowledge-based industries are typically high value added and high wage. Advanced manufacturing, in particular, is an especially powerful engine of job creation, as it generates both white collar and blue collar jobs. For this reason, many countries regard attracting foreign companies in these sectors and encouraging home grown companies as national priorities. They employ a variety of tax and non-tax incentives to achieve this objective.

Tax incentives include Innovation boxes (also referred to as patent boxes or IP boxes), which segregate profits resulting from the creation or utilization of intellectual property and apply a tax rate to these profits that is significantly below the general tax rate. This approach may be especially well-suited to the U.S.

A number of countries also utilize other tax incentives in addition to, or instead of, an innovation box to support knowledge-based industries. These include targeted tax credits, preferential tax rates, targeted accelerated depreciation/amortization, tax deductions, including “super” deductions, tax exemptions, tax withholding incentives, and VAT incentives.

Some commentators have advocated against an IP Box or other targeted incentives by arguing that they put the government in the position of picking commercial winners and losers, an exercise they believe is neither appropriate nor effective. An IP Box regime, for example, can certainly incentivize innovations through preferential tax treatment. By definition, an IP box will have its most important impact on knowledge-based industries. But this is a broad category, and encouraging such industries is certainly quite different than trying to pick a particular company or even a very specific sector such as green energy. As a group, knowledge-based industries are high wage, high value added, and the industries in which the U.S. is struggling to retain its current comparative advantage. They are sectors

³ The American Job Creation Act of 2004 allowed a one-time repatriation of earnings held abroad to the U.S. at a very low tax rate. This legislation was unsuccessful in stimulating productive investment, demonstrating that a one-time windfall has very different effects than a permanent change in incentives in altering corporate behavior.

where the problem is not simply incentivizing activity but competing with incentives offered by other countries in today's global market.

Another consideration in protecting the competitiveness of U.S. companies is the possible implementation of initiatives across Europe that attempt to limit tax benefits without appropriate local country substance or presence. These initiatives spearheaded by the Organization for Economic Co-operation and Development (OECD), and termed the Base Erosion and Profit Shifting (BEPS) initiatives, could increase pressure on U.S. companies to move employment and investment abroad in the absence of a domestic IP Box regime.

B. Designing An Innovation Box

The OECD has defined a "patent box" or "Intellectual Property ("IP") Box"⁴ as a preferential tax regime offered by a country to support growth and innovation.⁵ Such tax incentives may include a combination of lower income tax rates and beneficial expensing / credit regimes to encourage companies to locate their intellectual property and related development activities in the local country.⁶

While the vast majority of IP Box regimes are in the European Union (EU), the impact to global business is not restricted to that region. These regimes can provide non-EU companies with tangible benefits of locating IP and production within the region. U.S. multinationals typically leverage complex tax planning techniques to increase competitiveness with their foreign counterparts. The common theme with each of these techniques is to ameliorate the high U.S. corporate income tax rate. The common effect is a sustained migration of economic activity and potential economic growth outside U.S. borders. This migration compounds the anti-competitive environment in the U.S. as Congressional efforts are focused on *preventing* migration instead of promoting *retention*.

As IP is a movable asset that does not generally require a fixed place for exploitation, an IP Box regime has the ability to significantly influence a company's decision on where to locate such IP and those economic activities related to such IP (e.g., development and manufacturing). IP Box regimes have developed historically in the EU, and by the end of 2014, 12 European countries operated an IP box regime.

All IP Box regimes attempt to provide tax benefits to companies locating their IP within such jurisdiction. At its most basic level, all IP Box regimes provide preferential tax rates for income generated from qualifying IP. These rates vary from 0% in Malta to 15.5% in France. However, each IP Box regime contains distinct features affecting the mechanics of the regime, and consequently, its attractiveness. These distinct features include the type of income and IP qualifying under the regime. In addition, advantageous expensing methodologies can increase benefits provided by a particular regime. Each of these items is discussed below.

⁴ An IP Box generally refers to a special tax regimes that provides tax incentives for profits derived from IP, including patents. For purposes of this paper, the umbrella of related tax regimes will be referred to as an "IP Box".

⁵ <http://www.oecd.org/ctp/beeps-frequentlyaskedquestions.htm>

⁶ *Id.*

1. Income Qualification

IP Box regimes take different approaches with respect to the type of income that qualifies for preferential treatment. Multinationals earn various types of income from their valuable IP – royalty income from licensing the intellectual property, capital gain income from the sale of such property, or income from product sales incorporating the IP, to name a few. Thus, as a first step, the IP Box must differentiate between IP income streams to determine the type of income qualifying for benefits. [Table 1](#) depicts the state of income qualification for EU jurisdictions as of the end of 2014.⁷ Not surprisingly, all IP Box regimes allow royalty income to qualify for beneficial treatment. Most regimes allow for capital gains from the sale of qualifying IP to benefit for lower tax rates, while roughly half the regimes allow product sale income allocable to imbedded IP to qualify for preferential tax treatment.

Type of Income	Jurisdiction												
	Belgium	Cyprus	France	Hungary	Liechtenstein	Luxembourg	Malta	Netherlands	Portugal	Spain	Nidwalden, Switzerland	UK	
Royalties	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	
Capital Gains	NO	YES	YES	YES	YES	YES	NO	YES	YES	YES	YES	YES	
Embedded IP	YES	NO	NO	NO	YES	YES	NO	YES	NO	NO	NO	YES	

Note that the qualification / disqualification of a certain type of income can significantly alter the attractiveness of a country's regime to a particular company or industry, and is especially necessary for efficient tax planning. For example, a manufacturing company that sells tangible products and allocates a significant portion of profits to such embedded IP would not find the French IP Box regime particularly attractive given such income does not qualify for preferential tax treatment. Instead, the company may find the Netherlands more attractive. Alternatively, an early-stage medical technology company that develops and sells its valuable IP upon maturation would likely avoid those countries that do not extend preferential tax treatment to capital gains.

Since the goal of a U.S. innovation box program would be to stimulate the maximum amount of economic activity and employment within the U.S., inclusion of embedded IP is crucial. Without such a definition of IP income, there would be no benefit for locating manufacturing based on IP within the U.S., even though manufacturing based on R&D rather than R&D alone will create the greatest value in terms of numbers of good jobs and volume of economic activity. Moreover, location of R&D is likely to be less impacted by tax factors than location of manufacturing.

2. Eligible Intellectual Property

A large differentiator across IP box regimes is the IP that qualifies for preferential tax treatment. The bundle of IP rights that may be exploited by a company vary across industries, and can include patents, trademarks, copyrights, formulae, inventions, know-how, trade secrets, software, design rights, contractual rights, licenses, systems, methods, customer lists, and technical data. This exhaustive list

⁷ Information from the table obtained, in part, from "Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations" Evers, Miller, Spengel (2014).

can provide a country flexibility to implement a program that promotes its policy goals, while allowing it sufficient opportunity to separate itself from other regimes. As described in [Table 2](#) below, all of the IP Box regimes include patents as qualifying IP.⁸ Other traditional IP, including software, copyrights and trademarks qualify in most of the jurisdictions.⁹

Type of IP	Jurisdiction											
	Belgium	Cyprus	France	Hungary	Liechtenstein	Luxembourg	Malta	Netherlands	Portugal	Spain	Nidwalden, Switzerland	UK
Patents	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
SPCs	YES	NO	YES	NO	YES	YES	NO	NO	NO	NO	NO	YES
Software	NO	YES	NO	YES	YES	YES	YES	YES	NO	NO	YES	NO
Copyrights	NO	YES	NO	YES	YES	NO	YES	NO	NO	NO	YES	NO
Trademarks	NO	YES	NO	YES	YES	YES	YES	NO	NO	NO	YES	NO
Designs / Models	NO	YES	NO	YES	YES	YES	NO	YES	YES	YES	YES	NO
Formulae and Processes	NO	YES	NO	YES	NO	NO	NO	NO	NO	YES	YES	NO
Know-How	NO	YES	NO	YES	NO	NO	NO	NO	NO	NO	YES	NO

3. Acquired Intellectual Property

Another important aspect to these IP regimes is whether acquired IP can qualify for preferential tax treatment, and if so, under what parameters. More specifically, whether IP existing at the time of application for the IP Box qualify and whether subsequently acquired IP qualifies. Please see [Table 3](#) for a depiction of these considerations across EU patent boxes.¹⁰

Type of IP	Jurisdiction											
	Belgium	Cyprus	France	Hungary	Liechtenstein	Luxembourg	Malta	Netherlands	Portugal	Spain	Nidwalden, Switzerland	UK
Existing IP	NO	YES	YES	YES	NO	YES*	NO	NO	NO	YES	YES	YES
Acquired IP	NO	YES	YES	YES	YES	YES*	YES	NO	NO	NO	YES	YES*

* under certain circumstances

A medical technology company that acquires and then develops IP from an early stage start-up may require an IP Box regime that allows acquired IP to qualify. Only a handful of IP Box regimes do in fact allow acquired IP to qualify. Where such IP qualifies, it may on the condition that the acquired IP does not, itself, qualify, but that any profits associated with related IP further developed from such acquired IP does. In practice, this can be difficult to administer, as a company would be required to allocate income to the different types of IP within a specific bundle (i.e., acquired software v. further developed software). This complication could be avoided if profits from manufacturing derived from acquired IP could qualify for either a full or reduced tax incentive regardless of the degree to which the IP is further developed. This would serve the goal of encouraging location of knowledge-based manufacturing industries in the U.S., even if not all the knowledge behind the product is developed domestically.

⁸ [Id.](#)

⁹ Subject to new rules that are promulgated by Action 5 of the BEPS initiatives.

¹⁰ Information from the table obtained, in part, from "Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations" Evers, Miller, Spengel (2014).

In summary, an IP box can be an important competitive tool for attracting and encouraging knowledge-based industries. It would be especially valuable to the U.S. in helping the U.S. to compete for these industries, both with countries that offer such an incentive and with countries that do not, but have a substantially lower base corporate rate or provide other tax or non-tax incentives for this type of industry. Key design features include the type of income from IP eligible for favorable tax treatment, the definition of IP for the purpose of the tax preference, and whether acquired IP is eligible for favorable tax treatment. Providing a reward for embedded IP is critical to incentivizing knowledge-based manufacturing industries.

Appendix A further illustrates the impact of different decisions on the shape of an IP box.

C. Other Targeted Tax Incentives

An IP Box regime is not the only mechanism a jurisdiction may use to encourage innovation through domestic tax policy. Countries throughout the world use a variety of tax levers to establish beneficial rates for locating IP and IP based industries within their borders. The following tax incentives are benefits provided by various countries:

- Tax credits
- Preferential tax rates
- Accelerated depreciation / amortization
- Tax deductions, including “super” deductions
- Tax exemptions and holidays
- Income tax withholding incentives
- VAT incentives

The application of these disparate mechanisms varies widely by jurisdiction, but all are focused on attracting investment, spurring domestic production and increasing competitiveness of their local businesses. For purposes of comparison to IP Box regimes, detailed below are three non-EU jurisdictions that leverage these tax incentives, as well as some non-tax benefits, to drive development of knowledge-based industries.

1. Brazil

- Super research and development deduction
- Accelerated depreciation
- Financial support

Brazil has a history of supporting research and development activities through tax policy, with many of its statutory tax benefits having been in place since 2006.

One such mechanism is the availability of a “super” deduction equal to 160-200% of qualifying research expenses. In addition, if a company has additional research expenses when compared to the previous year, the company can apply for an additional “super” deduction of 160-180%. This policy encourages companies to not only invest in local research activities, but also ensure their research expenses increase year-over-year. This policy can certainly help drive innovation, especially for small or immature companies looking to grow rapidly.

In addition, Brazil allows accelerated depreciation for assets used in current research investment. This accelerated depreciation can ensure a 100% deduction of research assets in the year of their acquisition. This immediate deduction can be a powerful driver of domestic production as companies consider the most efficient use of their funds. Companies would materially benefit from the bottom line tax benefit and could allocate these additional resources back into their business.

Finally, the Brazilian government offers financial support with reduced interest rates for up to 90% of a project’s cost. This program requires a pre-approval process but can help alleviate high infrastructure costs, especially for growing companies that present risky investment for established banks.

Generally, these tax benefits are available to a wide variety of technological innovations and industries through a broad definition of qualifying innovation which include not only new products but also technological advances on existing products. This broad base allows taxpayers to significantly reduce their corporate tax burdens from Brazil’s current 34% rate.

2. China

- Technologically Advanced Service Credit (TASC) & High-New Technology Enterprise (HNTE) tax regime
- Tax holidays
- Reduced tax rates / exemptions
- Super R&D deduction

China offers very competitive research and development benefits, especially for those companies eligible for their high technology company regimes – the TASC and HNTE. These regimes can significantly decrease the effective tax rate of the company well below China’s standard 25% corporate income tax rate.

Companies that qualify as a Technologically Advanced Service Company (TASC) receive the following benefits through 2018:

- A reduced 15% corporate income tax (down from 25%)
- Exemption from business tax / VAT on certain offshore services
- Increased deduction limitation for employee education expenses (8%)

Companies that qualify for High-New Technology Enterprise status (HNTE) receive the following benefits:

- A reduced 15% corporate income tax (down from 25%)
- For those established in specific economic zones¹¹ or in the Shanghai Pudong New Area, a tax holiday for the first year it derives operating income

Both the TASC and HTNE regime have certain eligibility requirements and require pre-approval from local authorities. These eligibility requirements are centered around IP ownership and ensuring that the IP is considered the type of key technology falling within the scope of the regime. In addition, the regimes may require minimum research and development spend, IP-related revenues and / or specialized headcount requirements.

For those companies that cannot qualify as TASC and HNTE companies, other tax benefits of wider application may be available. One such benefit is a “super” deduction allowing a resident Chinese company to deduct 150% of qualifying research and development expenses in calculating taxable income. In addition, China provides an income tax exemption for certain technology transfers and VAT exemptions on technology development and outsourced technology services. Each of these benefits requires pre-approval from the tax authorities, but can provide tangible tax benefits to a local entity.

3. India

- Tax holidays (SEZ Scheme)
- “Super” deductions
- Financial support

India has been one of the worldwide leaders of encouraging innovation through domestic tax policy, with a clear mandate to support local research activities. From a tax perspective, India offers a variety of tax benefits, including tax holidays, super deductions, financial support, tax exemptions and reduced rates.

More specifically, India allows tax holidays for companies established in certain special economic zones (SEZ). These holidays can provide a 15 year tax benefit period for certain export profits, including a 100% tax holiday for the first 5 years, followed by 50% holidays for the next two successive 5-year periods.

Companies outside the SEZ scheme can benefit from a “super” deduction up to 200% on certain expenses paid to national laboratories and universities conducting specific, pre-approved research projects; a deduction up to 175% for general contributions to approved research institutions, and 125% for basic research and development costs. These benefits have dual effects – (i) to provide companies with tangible tax benefits related to research activities and (ii) to encourage companies to re-invest in

¹¹ The special economic zones are located in Hainan, Shantou, Shenzhen, Zhuhai, Xiamen

Indian infrastructure by funneling research funds to Indian research institutions. This reinvestment can provide exponential growth opportunities domestically and drive growth.

In addition, Indian companies can benefit from grants and loans provided by the Indian governments under the Technology Development Program (TDR). As the name implies, companies and trade associations can be afforded financial support on pre-approved projects focused on developing new technologies or adapting current technologies for a wider-use application.

Each of these incentives provides Indian companies with tangible encouragement to drive domestic innovation and local reinvestment. It is this dual approach to technological development that is the hallmark of the Indian tax system, one that has made India a technological hub in this global economy.

II. Non-Tax Incentives

In addition to innovation incentives that operate through their tax laws, many of America's trading partners are increasing their spending on grants or other mechanisms to support innovation and knowledge based industries. Brazil's reduced interest loans and India's TDR program have already been mentioned. While it would be impossible to catalogue all of these programs (some are at the national government level, some local) the following are examples of major initiatives in this area:

1. The European Union – Horizon 2020.

Stating that "innovation has been placed at the heart of the EU's strategy to create growth and jobs," the European Union has agreed to an innovation agenda in which its members are encouraged to invest 3% of their GDP in research and development by 2020 (1% from public funding, 2% from private sector investment) to address the larger challenges facing the planet, including energy, food security, climate change, health and the aging population. According to the EU release, the purpose of the innovation agenda is to "remove bottlenecks which prevent ideas from reaching the market – including lack of finance, fragmented research systems and markets, under-use of public procurement for innovation and slow standard-setting."

As part of this program, the EU in 2014 created a pool of 80 billion euros (2014 through 2020) in funding for science research (25 billion), industrial innovation (17 billion), and social issues (climate change, food security), which will be used to help ensure that technological breakthroughs including new processes are developed into viable products with commercial potential through government/private sector partnerships. Innovators wishing to participate in this program must submit proposals through an EU portal.

2. The World Bank.

The World Bank also directs some of its lending to government towards the development and

commercialization of innovation in the following areas: support for private and public research and development, strengthening entrepreneurial capabilities, financial support for early-stage start-ups, and fostering linkages between actors in the innovation system. A recent World Bank report found that over the decade between 2002 and 2012 the Bank had developed an investment portfolio of close to \$19 billion for innovation and entrepreneurship activities.

3. Particular Country Programs.

Besides the investment of various international organizations, particular nations have well-developed innovation policies through which they directly support local innovators. The United Kingdom, for example, has established the U.K. Innovation Investment Fund. The Fund is designed to coordinate private and government sector investment in securing financing for innovation by small and medium enterprises, the commercialization of that innovation, and the development of business leadership and management skills. The spending goal for the current U.K. innovation program is around 5 billion pounds a year with a goal of supporting 26,000 British small and medium enterprises.

In 2010 Russia established the Skolkovo Innovation Center outside of Moscow with the intention of creating a Silicon Valley type of location where high-tech innovation could be developed and products brought to market. In establishing this Center, the Russian Government noted that it lagged behind the U.S. in research spending and was hoping to develop, aided by direct subsidies from the government, thousands of start-ups to provide a research base that would eventually grow the economy.

4. Sovereign Wealth Funds.

Sovereign wealth funds (SWFs) are state owned investment funds that are established from the balance of payment surpluses, foreign currency operations, proceeds from the privatization of formerly state-owned enterprises, fiscal surpluses, and revenues from resource exports. While funds of this type have existed since the 1950's (it is believed that the Kuwaiti Investment Fund was the first SWF), the number has proliferated over the past decade and the term SWF was first used in 2005.

The World Bank has identified three general groupings of SWF's: (1) stabilization funds, which have as their primary function to protect the domestic economy from trade revenue fluctuations mostly in commodity prices. These SWF's invest generally in heavily developed markets where they purchase stable long-term assets with a concentration in stable bonds; (2) savings funds, which are designed to convert wealth derived from nonrenewable natural resources, oil and gas, for example, into a diverse investment portfolio for the benefit of future generations; not surprisingly many of these were established by major oil producing states; and (3) reserve investment corporations that reduce the opportunity cost of holding excess foreign reserves by investing in ventures with potentially higher returns; as a result, this type of SWF has the most aggressive investment profile, takes greater risk than the others, and is very secretive. It is this category that is most likely to be used to support innovation and start-up enterprises that pose a greater risk profile.

Because SWFs are the creature of governments, many of which do not have public disclosure or transparency rules and are not regulated by international organizations, there is limited detailed information about them. Various sources estimate the assets under management in SWFs to be in the range of \$20 trillion and growing.

A recent report on SWFs from the Federal Reserve Bank of Dallas stated that “as of July 2013, 61% of SWFs were actively invested in infrastructure – both domestically and internationally,” and noted that “SWFs can afford to invest in experimental, socially responsible ventures that have not yet attracted private capital.” SWFs could in that regard become a major source for the funding and commercialization of research and innovation.

III. PRE-REVENUE START-UPS

In the absence of robust grant programs to support pre-revenue start-ups, American innovators often find themselves stuck in the so-called “valley of death,” the period in between the invention of a viable commercial product and its commercialization. The lack of funding during this critical pre-revenue period can doom a company and deprive a nation of the economic growth it could generate, as well as the benefits of the invention itself. Unfortunately, the inability to raise capital in the U.S. has resulted in many innovators going overseas to obtain funding for their ideas.

Although a reduction in tax rates, as discussed above, would likely provide a very beneficial boost to the global competitiveness of American companies, reduced rates do little for pre-revenue start-ups: because they have no income subject to tax, adjustments to the tax rates do not help them. As a result, if tax reform focuses solely on rate reduction it will do very little to support the smaller entrepreneurs who drive most of American innovation.

As Congress considers tax reform there are a number of tax-driven programs that could provide financial support to pre-revenue start-ups and keep them in the U.S.

A. Passive Activity Loss Relief.

In an effort to address the concern that some partnerships had been created for the sole purpose of generating tax losses for their investors with no clear intent to ever produce a profitable product or service, Congress in 1986 changed the law to prevent passive investors (those who do not materially participate in running the business) from taking losses generated by the business against their unrelated incomes. A change in the passive activity loss rules directed towards partnerships that undertake considerable research for the development of high technological products, and that have no more than 250 employees and relatively low assets, would attract domestic investors and protect against the concerns that were at the core of the reforms that Congress enacted in 1986.

B. Angel Investor Credit.

Adopted already in a number of states, the angel investor credit would provide investors in small businesses a tax credit. In one version, eligible investments were defined as those in companies in existence for less than five years with less than 100 full-time employees and headquartered in the U.S. The credit was equal to 25% of the angel investment, limited to \$2,000,000 a year and a total of \$10,000,000 over five years.

C. Capital Gains Reform.

In the recently enacted PATH Act, Congress made permanent rules permitting investors to exclude from their incomes 100% of their gains on the sale of qualified small business stock (QSB). To qualify as QSB the small business entity must have gross assets below \$50 million. While the concept of capital gains relief is an effective way to attract investment, the threshold for defining a small business is too low for many capital-intensive startups and should be raised to at least \$150 million.

IV. Highlighting the Differences.

The marketplace is global and American innovators have greater options and incentives than ever before to raise capital and locate their operations overseas. The challenges America faces as it seeks to retain and build its knowledge-based, innovative industries in a global economy can perhaps best be illustrated by comparing the different tax treatments and other benefits domestically based activities would receive abroad compared to those available to similar companies in the U.S.

These are difficult comparisons to make because every tax system is complex in its own right and there are numerous factors that have an impact on the overall tax burden that any company faces. Moreover, it is imperfect to compare only statutory tax rates (i.e., the set rate under the law) because the use of deductions, credits, and other forms of tax planning can bring that rate down to a significantly lower effective rate, which is defined as the total amount of income tax divided by pre-tax income.

Nonetheless, the comparisons that follow demonstrate that innovators may find the basic tax rules in many foreign jurisdictions to be far more beneficial than those in the U.S.

A high-tech company in the U.S. is subject to Federal corporate tax at a 35% rate on taxable income over \$10,000,000 (the rate is graduated below that amount at a 15% and 25% rate) and is eligible for a credit for research and experimentation that is computed against incremental research

over a historical base. Currently the U.S. has no form of innovation box or special tax incentive rates for high-tech industries, and limited non-tax incentives at the Federal level. Most states also tax corporate income adding another potential layer of taxation. The company might be eligible for a small, early-stage grant from NIH or receive some modest benefits by locating its operations in a state-run technology incubator facility.

The U.S. taxes individuals and corporations on their worldwide incomes meaning that an American company with profits exceeding \$10,000,000 is taxable on all of its worldwide income at the full 35% corporate rate. Global U.S.-based companies generally operate outside of the U.S. in the form of foreign controlled corporations that are not subject to immediate U.S. taxation, but to the extent that the profits of those foreign corporation are brought back to the U.S., usually in the form of dividends paid to the U.S. parent corporation, they are subject to tax at the 35% rate. There are estimates that U.S. companies are holding well in excess of \$2 trillion in foreign profits overseas in order to avoid this high level of taxation.

By comparison a company resident in Ireland is subject to a corporate tax of 12.5%, and while Ireland also taxes on a worldwide basis, the tax is reduced by credits for taxes paid in other jurisdictions and Irish companies can also defer taxation in Ireland by operating through controlled foreign corporations. Ireland provides a research credit of 25% of research expenditures during the year, which includes the cost of buildings and improvements used for research activities. Ireland is also in the process of implementing a so-called "knowledge box" under which income from the development and commercialization of innovative technologies would be taxed at half the corporate rate, or 6.25%. The rate and research credits in Ireland are without question less burdensome than the U.S. corporate rate, and the U.S. does not have any type of innovation box regime at this time.

Israel has been very aggressive in attracting innovators, especially in the sciences. Currently Israel taxes corporate income at a 26.5% rate and has aggressive programs to provide direct grants for research ranging from 20% to 50% of outlays for research activities, and those grants are increased to the extent that a company may be located in one of two special research zones. Israel also provides special grants for the development of life sciences technologies, in addition to an "angel investor" credit to encourage investment in start-up high-tech companies.

In the case of Israel, the corporate rate is lower than the U.S. rate, although not as low as the Irish rate, but Israel has a robust subsidy program to encourage innovation in start-up pre-revenue companies.

The U.K. has decided to follow the lead of Ireland and several others of its European trading partners. The country has recently enacted further reductions in its corporate tax rate, which is currently set at 20%, but will drop to 19% in 2017 and 17% by 2020. There are no local corporate taxes in the U.K.

The U.K. taxes on worldwide income but there are exceptions to the worldwide taxation requirement for cases where the foreign entity engages in genuine economic activity abroad, i.e., by maintaining a permanent establishment in a foreign country. As noted earlier, Britain has a patent box regime that reduces even further the corporate tax burden on income derived from the commercialization of innovative technologies and an innovation fund that provides financing to high-tech start-ups.

In each of these cases, the corporate rate is significantly lower than the U.S. rate. Even where there is worldwide taxation, because the rate is low and credit is available for taxes paid to other jurisdictions, the likelihood is that the tax system will operate as territorial as a practical matter.

A U.S. company earning profits in Ireland, for example, will be subject to tax on those profits at the 35% rate, with 12.5% of that tax paid to Ireland and the rest to the U.S. The only way to avoid the high level of taxation by the U.S. would be to defer it by keeping the profits outside of the U.S. in a controlled foreign corporation, in which case the profits would only be subject to Irish tax when earned but would be taxed at the full U.S. rate when brought back into the U.S. By contrast an Irish company would be subject to the lower Irish rate generally while only its profits from sales in the U.S. would be subject to the U.S. tax (which is so much higher than the Irish tax that there would be no Irish tax on those profits in any event). The local corporate rates in all three of these examples, and in the case of most U.S. trading partners, are much lower than the U.S. rate.

These examples are also representative of countries that do more to promote innovation. The U.K. has a patent box that reduces the tax burden further on high-tech income, Ireland has a generous research credit and is implementing an even more generous knowledge box, while Israel has a robust subsidy program to support innovation.

While it is extremely difficult to compute the effective tax rate a company would have in all of these jurisdictions without extensive detail as to its likely operations (which might be structured differently in any event in each of the jurisdictions to take advantage of particular rules) in Ireland, Israel, and the U.K., business taxes begin with a lower rate than the U.S. which would likely result in an even lower effective rate as deductions and credits are taken against income. Using a very general methodology, a PWC/Business Roundtable Report issued in 2011 concluded that of sixty nations surveyed, the U.S. effective rate was the sixth highest, just slightly less burdensome than the rates in Germany, Indonesia, Italy, Morocco, and Japan. Of these, Germany and Japan have dramatically lowered their rates since the study, as have a number of countries that were less burdensome than the U.S. to begin with, most notably, the U.K.

A just released advance copy of a report by the International Monetary Fund (IMF) entitled "Acting Now, Acting Together" highlights the extent to which the US has fallen behind in promoting innovation. Among its findings the U.S. is at the low end in providing tax incentives to promote research and development (behind Korea, France, Slovenia, Belgium, Austria, Ireland, Canada, the U.K., Japan, the Netherlands, Australia and Portugal), while it does not even appear on a chart of the nations that

provide more generous research and development incentives to smaller, rather than larger, firms (Japan, Norway, Australia, the Netherlands, Korea, Chile, the U.K., Canada and France). And, not surprisingly, the report cites the high U.S. corporate rate as a major impediment in attracting innovators and notes that the business entry rate, a measure of entrepreneurship, has declined steadily in the U.S. since the 1970's.

Congress has debated tax reform for over a decade, with key Congressional Leaders on both sides of the aisle in agreement that the current U.S. tax system contributes to the trends noted in the IMF Report. We need to do better.

Conclusion

In its most recent consultation report in the Spring of 2015, the International Monetary Fund concluded the U.S. economy was performing below potential and recommended, among other policies, comprehensive tax reform, which it characterized as "long overdue," as well as "supply-side measures that support future growth, job creation, and productivity"...including "incentivizing private innovation."

While the U.S. has struggled to find a consensus for tax reform and is engaged in a debate over whether it is appropriate for government to subsidize business, its trading partners have dramatically reduced their corporate tax rates while creating tax-driven incentives for innovators and have set in motion both on the international level and domestically programs that are intended to match and even exceed the historical levels of research and innovation spending in the U.S. economy.

By contrast, the U.S. basically offers a high corporate tax rate, very limited incentives for investors in high-tech start-ups, and a research credit that is of very limited value and extremely difficult to calculate and claim, as well as an overall tax system that encourages companies to move facilities overseas and keep their foreign profits offshore.

In order for the U.S. to stem the tide of innovation moving offshore, much more is needed. The U.S. tax system should be reformed comprehensively to include a significant reduction in the rates imposed on business income; modification of the current system of taxing American businesses on their worldwide incomes; creation of special tax incentives for knowledge-based, high value-added industries to level the playing field with competitor nations; and development of special incentives to encourage investment in start-up companies.

The enactment of major reforms takes time in the American system of government, but in this instance, time is running out. Once the leader in global innovation, the U.S. is increasingly falling behind as competitor nations enact new tax systems and support programs to spur innovation in knowledge-based industries and grow their economies.

APPENDIX A: Illustrative Patent Box Regimes**Review of Certain IP Box Regimes**

For comparison purposes, provided below is a more detailed review of IP Box Regimes in Hungary, Luxembourg and Belgium. These countries' IP box regimes range from the most generous (Hungary) to the most restrictive (Belgium). The comparison can best illustrate the different factors that go into creating an IP Box, as the base tax rate alone is not indicative of the benefit it can provide. Instead, those factors described above, e.g., qualifying income and qualifying IP are more substantive indicators of an IP Box's benefits than the stand-alone preferential rate afforded by the regime. These key features are the political pressure points that a jurisdiction must navigate to implement an IP Box regime that successfully meets its stated goals and provides requisite benefits to attract investment.

A. Hungary

- Preferential Tax Rate: 9.5%
- Qualifying Income: Royalty, Capital Gains
- Qualifying IP: Patents, Software, Copyrights, Trademarks, Designs, Formulae, Know-How

Hungary's IP Box regime is generally considered the most generous even though the base tax rate is higher than some of the other IP Box regimes. Hungary's IP box regime allows a 50% deduction for qualifying income earned from related or unrelated parties, up to 50% of pre-tax income. Hungary allows a wide variety of IP to qualify for the preferential rate other than patents, including income allocable to software, copyrights, trademarks, designs, formulae and know-how. This range of IP may be attractive to a number of different types of companies across multiple industries. In addition, Hungary allows *both* internally developed IP and acquired IP to qualify for the regime. This encourages mature companies to move valuable IP into the jurisdiction and benefit from the lower rates without an emphasis on further development required in other IP Box regimes. In addition, capital gains related to the sale of qualifying IP create an incentive for companies that desire flexibility on exit of their investment.

Although some of these same features are available in other jurisdictions, it is Hungary's expense mechanism that provides a substantial benefit not found elsewhere. Generally, an IP Box regime's benefits can be influenced by the country's treatment of expenses related to the qualifying IP. Countries either take a "gross income" or "net income" approach. Under the "gross income" approach, a company is allowed to deduct IP expenses at the gross income level, meaning that IP expenses can reduce both qualifying IP income and non-qualifying income. A "net income" approach instead segregates IP income first and then allocates qualifying expenses to that IP income without a cross deduction for non-qualifying income. Hungary's gross income approach provides an opportunity for companies with significant non-qualifying income to effectively benefit from the IP Box regime with the added bonus of reducing income on non-qualifying activities. This somewhat counterintuitive expense regime separates Hungary from other jurisdictions, as only Belgium, a far less beneficial regime, allows deductions to be taken from gross income in this manner.

Summarily, Hungary's IP Box regime is one of the most beneficial IP Box regimes due to the flexibility it provides in allowing a wide variety of IP to qualify and the ability for companies to use the IP Box for established IP and for IP that may be divested in the future. In addition, the IP expense regime in Hungary creates opportunities for companies to realize significant benefits through a cross-deduction of IP expenses against non-IP income.

a. Luxembourg

- Preferential Tax Rate: 5.76%
- Qualifying Income: Royalties, Capital Gains, Certain IP-Embedded Sales Income
- Qualifying IP: Patents, Trademarks, Designs, Domain Names, Models, and Software Copyrights

Luxembourg's IP Box regime can be considered moderately beneficial, as many of its key features are "middle of road" in terms of benefits and restrictions. The preferential tax rate of 5.76% is relatively beneficial when compared to other regimes and the qualifying IP includes many different types of IP, but excludes non-software related copyrights, know-how and formulae. While Luxembourg does allow acquired IP to qualify for preferential treatment, certain conditions exist to limit its availability. More specifically, the IP obtained by the Luxembourg company cannot be acquired from a direct parent company, a direct subsidiary or a direct brother-sister company with a direct common parent. Although this may appear to be a significant hurdle to related-party transfers of IP, it may be possible to structure the acquisition from an eligible affiliate.

Luxembourg's IP regime does not require the Luxembourg company to be the legal registrant of the IP, meaning the beneficial rights to the IP (as opposed to legal rights) may be transferred between related entities, effectively saving the cost and administration of legally registering and tracking the IP in different jurisdictions. In addition, IP box benefits accrue even if the IP is not developed in Luxembourg.

In terms of qualifying income, Luxembourg's regime is somewhat generous. Besides royalty income, capital gains on the disposition of eligible IP qualifies for preferential treatment. Unlike many jurisdictions, the sale of IP imbedded products may qualify, but only with respect to self-developed patents. This can be a significant hurdle for companies, as those with acquisitive histories may find it difficult to satisfy this requirement, at least in the immediacy after acquisition.

b. Belgium

- Preferential Tax Rate: 6.8%
- Qualifying Income: Royalties, IP-Embedded Sales Income
- Qualifying IP: Patents, SPCs

Belgium's IP Box regime is generally considered one of the least beneficial regimes. Although the preferential tax rate is competitive with other IP Box regimes, it is the nuanced limitations of the regime that complicates its qualification and erodes its benefits.

One main detraction is the limited types of IP that qualifies for the regime. Only patents and SPCs qualify, and only those granted or first commercially used on or after January 1, 2007. Other types of IP, including know-how, trademarks, designs, models, formulae and processes are specifically excluded under Belgian law. Furthermore, existing and acquired IP do not qualify for the regime, although improvements to such IP would. These improvements are not required to result in additional patents, however.

In addition, certain harsh affirmative requirements must be met related to IP development to guarantee qualification. The patent development work must be performed by a research and development center that is owned by the Belgian entity. The work need not be performed in Belgium, and may be performed by related or unrelated subcontractors, but the Belgian company must have sufficient substance to supervise the research activity. The research center must qualify as a branch or line of business that operates independently within a given entity.

Only royalties and deemed royalties from IP embedded in manufactured products qualify for the regime. Capital gains from the sale of such qualifying IP is specifically excluded. One beneficial aspect of the regime is that research and development costs are deductible at the standard 34% rate, while research credits may be claimed in addition to the preferential IP rate. Therefore, companies can likely reduce the effective tax rate on qualifying income well below the 6.8% rate.

On the whole, the Belgian IP Box regime lacks the beneficial attributes seen in other regimes. The fact that acquired IP does not qualify for the box likely steers away mature companies looking to take advantage of IP box benefits. Also, the significant limitations on where and how the patent improvements are made lack the flexibility multinationals desire when determining tax planning strategies.

D. Boustany/Neal Proposal

Representatives Charles Boustany (R-Louisiana) and Richard Neal (D-Massachusetts) have released a proposal under which patent box profits would be taxed at a 10% rate rather than the current 35% corporate rate. To determine patent box profits, however, the taxpayer first must determine its IP profits -- gross receipts from the sale, lease, or other disposition of qualified patent property (any patent, invention, formula, process, design, pattern, know-how, computer software, and motion picture film or video-tape or any product produced using any of the foregoing) -- over costs of goods sold that are allocable to patent gross receipts and other allocable expenses, and multiply these by the ratio of the taxpayer's research and development costs over total costs for the past five years. The resulting amount, patent box profits, are subject to a 71% exclusion from tax resulting in a tax rate on those profits of around 10% at a 35% rate.

While the definition of IP profits is generous in that it covers much more than income derived from traditional patents, the use of the ratio that considers how much of a taxpayer's costs were related to research and development tends to result in a very limited benefit (a reduction of two or three points

in the corporate rate) except in industries in which domestic research is, even for a knowledge-based industry, an especially large expense relative to the cost of goods sold. This is an especially challenging standard for knowledge-based manufacturing industries. Combined with the already high U.S. corporate rate, the Boustany/Neal innovation box is conceptually a step in the right direction but will do very little as a practical matter to address the issue of America's competitiveness in global innovation for many industries. Boustany and Neal have requested comments on their proposal and are considering a number of suggestions to address this issue, including the relaxation of the research/costs ratio and the use of a different formula that would simply apply a lower rate (15% for example) to IP profits without the ratio.

Statement by the
Association of Equipment Manufacturers
Milwaukee, WI

U.S. House of Representatives
Committee on Ways & Means
Subcommittee on Tax Policy

Hearing on “Perspectives on the Need for
Tax Reform”

Wednesday, May 25
1100 Longworth House Office Building
Washington, D.C.

The Association of Equipment Manufacturers (AEM) welcomes the opportunity to submit a written statement for the record of the Committee on Ways and Means Subcommittee on Tax Policy Hearing on "Perspectives on the Need for Tax Reform."

AEM is the North American-based international trade association providing innovative business development resources to advance the off-road equipment manufacturing industry in the global marketplace. AEM membership comprises more than 850 companies and more than 200 product lines in the agriculture, construction, forestry, mining and utility sectors worldwide.

Manufacturing employs nearly 12 million men and women, contributes more than \$1.8 trillion to the U.S. economy annually, has the largest economic impact of any major sector and accounts for two-thirds of private-sector research and development.

AEM members know firsthand that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. As a result of manufacturing's critical importance to our nation's economy, any effort to rewrite the federal tax code should result in a balanced, fiscally responsible plan that allows manufacturers in the United States to prosper, grow and create jobs and enhances their global competitiveness.

We applaud Chairman Boustany, Ranking Member Neal and the other members of the Subcommittee on Tax Policy for holding a hearing about comprehensive tax reform. It is a critical topic that needs to be addressed when considering how to make the United States a more attractive place to invest and create jobs and how to help keep the U.S. manufacturing industry competitive in the global economy.

As the Subcommittee on Tax Policy continues to work on crafting a comprehensive, pro-growth tax plan, AEM would like to provide an overview of a few elements we believe ought to be part of any meaningful tax reform effort.

First, lower the corporate tax rate. As other nations have realized, a significant cut to corporate tax rates would encourage businesses both at home and abroad to invest in the United States.

Second, do away with the worldwide structure and implement a tax territorial tax system like those in most other industrialized nations. This would provide a level playing field for American companies operating in markets at home and abroad.

Third, comprehensive tax reform also presents an opportunity for creative thinking on investing in our nation's infrastructure. We encourage the Subcommittee on Tax Policy to make infrastructure investment part of comprehensive tax reform.

Lastly, give thoughts to the type of jobs you want in the United States. Other countries have given this serious consideration and built their tax structures around a desire to maintain a manufacturing base versus moving strictly to services-based economies.

We thank Chairman Boustany, Ranking Member Neal and the members of the Subcommittee on Tax Policy for diligently leading the conversation about comprehensive tax reform. Equipment manufacturers recognized the need to attract high-value jobs and investments to the United States and improve the competitiveness and the urgent need for commonsense reforms of our tax system. We look forward to further discussions of this critically important issue and to working with you and your staff to achieve a pro-growth, pro-competitiveness and pro-manufacturing tax system.





**Statement of the
American Farm Bureau Federation**

**SUBMITTED FOR THE RECORD
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TAX POLICY**

HEARING ON PERSPECTIVES ON THE NEED FOR TAX REFORM

MAY 25, 2016

Reform of the tax code will drive economic growth, spur business expansion and contribute to job creation in the agriculture sector. Farm Bureau appreciates the opportunity to submit this statement on tax reform for the record for the House Ways and Means Tax Policy Subcommittee hearing on “Perspectives on the Need for Tax Reform.”

Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We believe that the new code should be simple, transparent, revenue-neutral and fair to farmers and ranchers. Agriculture operates in a world of uncertainty. From unpredictable commodity and product markets to fluctuating input prices, from uncertain weather to insect or disease outbreaks, running a farm or ranch business is challenging under the best of circumstances. Farmers and ranchers need a tax code that recognizes the financial challenges they face.

Tax reform should embrace the following overarching principals:

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

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

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

Cash Accounting: Cash accounting is the preferred method of accounting for farmers and ranchers because it provides the flexibility needed to optimize cash flow for business success, plan for business purchases and manage taxes. Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This gives them the flexibility they need to plan for major investments in their businesses and in many cases provides guaranteed availability of some agricultural inputs. Loss

of cash accounting could create a situation where a farmer or rancher would have to pay taxes on income before receiving payment for sold commodities.

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

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

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

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

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





1
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**Statement for the Record
 of the
 Bond Dealers of America
 to the
 House Committee on Ways & Means
 Subcommittee on Tax Policy
 Hearing on Perspectives on the
 Need for Tax Reform**

May 25, 2016

This statement is submitted on behalf of the Bond Dealers of America (BDA), the only Washington, DC-based association representing the interests of middle-market securities dealers and banks focused on the U.S. fixed income markets. We write to urge the U.S. House of Representatives Committee on Ways and Means Subcommittee on Tax Policy to retain current law as it applies to the tax-exemption for municipal bonds in order to preserve the most effective and efficient financing method for our nation's critical infrastructure.

Investment in schools, education loans, transportation, housing, healthcare clinics, non-profit hospitals, electrical facilities, water and wastewater treatment systems, police, fire, ambulance services, and other public infrastructure is critical to a growing and well-functioning economy. For over 100 years, tax-exempt municipal bonds have been used by state and local governments to finance infrastructure and community improvement projects including schools, hospitals, roads, highways, bridges, subways, seaports and marine terminals, water and wastewater facilities, multi-family housing, libraries and town halls, electric power and natural gas equipment for city-owned utilities, and other public projects. Infrastructure financed by municipal bonds makes possible nearly every aspect of daily life and are a critical component in building and maintaining a strong economy for every citizen and company in this country. Attempts to curb or repeal the municipal exemption would dramatically increase the cost of infrastructure to the public and undermine the efforts of America's state and local governments to move their communities forward.

In recent years, both Congress and the Obama Administration have put forth proposals to cap the value of the tax-exemption tied to municipal bonds. These proposals would have the resultant effect of increased borrowing costs for state and local governments, which, in turn, would drive up infrastructure costs significantly. Such a dramatic increase could leave issuers with few choices other than to raise taxes, utility rates, and user fees or to direct less capital toward public infrastructure. None of these options is desirable to any state or local government or to taxpayers and businesses, especially at a time when the country is seeking ways to jump-start the economy—an economy that places a heavy reliance on well-functioning, up-to-date infrastructure.

An abundance of caution should also be placed on the negative consequences to investors and the municipal market from proposals seeking to alter the tax treatment of municipal bonds. Taxing a

previously untaxed security would destroy investor confidence and create volatility and uncertainty in the historically stable municipal bond market. Federal legislative proposals to restrict the tax exemption that have been released (or rumored to exist) in the last two Congresses have sent tremors through the municipal markets. The perceived risk to the tax exemption led some investors to seek higher yields on municipal bonds and to pull much-needed capital and liquidity out of the municipal markets. This, in turn, forces municipal governments to pay significantly higher issuance costs—and the continuing domino effect forces some governments to reduce or abandon infrastructure projects they can no longer afford.

Finally, proposals to reduce the value of the tax-exemption would have its greatest negative impact on investors. Elderly Americans (those over age 65) own three-fifths of outstanding municipal bonds, which provide a stable, fixed income to retirees. Moreover, roughly one-half of municipal bond interest is paid to households with annual income of less than \$250,000. Capping the value of the tax exemption would reduce the value of outstanding municipal bonds by roughly \$200 billion with the market erosion falling most heavily on middle-income investors—some of whom may have their entire retirement portfolios invested in municipal bonds.

Chairman Boustany, as the Subcommittee continues its examination and deliberations on ways to reform our federal tax code, we strongly urge you to look beyond the words and calculations in the tax code to the real world implications of proposals to change current laws governing the tax-exempt status of municipal bonds. A key step in rebuilding our economy is providing cost-effective financing for our nation's infrastructure. Tax-exempt municipal bonds are the only proven mechanism to accomplish this task. The current law tax-exemption for municipal bonds must be preserved.

Sincerely,



Michael Nicholas
Chief Executive Officer
Bond Dealers of America



**Comments for the Record
United States House of Representatives
Committee on Ways and Means
Subcommittee on Tax Policy
Hearing on Perspectives on the Need for Tax Reform**

Wednesday, May 25, 2016, 2:00 P.M.

**By Michael G. Bindner
Center for Fiscal Equity**

Chairman Boustany and Ranking Member Neal, thank you for the opportunity to submit these comments for the record to the Tax Policy Subcommittee. As usual, we will preface our comments with our comprehensive four-part approach, which will provide context for our comments.

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of \$100,000 and single filers earning \$50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25%.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

Our comments will address our perspective on each consideration identified in the Hearing Advisory and how our four-part approach meets them.

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 \$1000 per month. Such money will undoubtedly be spent by the families who receive it on everything from food to housing to consumer electronics.

The high income and inheritance surtax will take money out of the savings sector and put it into government spending, which eventually works down to the household level. Growth comes when people have money and spend it, which causes business to invest. Any corporate investment manager will tell you that he would be fired if he proposed an expansion or investment without customers willing and able to pay. Tax rates are an afterthought.

Our current expansion and the expansion under the Clinton Administration show that higher tax rates always spur growth, while tax cuts on capital gains lead to toxic investments – almost always in housing. Business expansion and job creation will occur with economic growth, not because of investment from the outside but from the recycling of profits and debt driven by customers rather than the price of funds. We won't be fooled again by the saccharin song of the supply siders, whose tax cuts have led to debt and economic growth more attributable to the theories of Keynes than Stockman.

Simplicity and burden reduction are very well served by switching from personal income taxation of the middle class to taxation through a value added tax. For these people, April 15th simply be the day next to Emancipation Day for the District. The child tax credit will be delivered with wages as an offset to the Net Business Receipts tax without families having to file anything, although they will receive two statements comparing the amount of credits paid to make sure there are no underpayments by employers or overpayments to families who received the full credit from two employers.

Small business owners will get the same benefits as corporations by the replacement of both pass through taxation on income taxes and the corporate income tax with the net

business receipts tax. As a result, individual income tax filing will be much simpler, with only three deductions: sale of stock to a qualified ESOP, charitable contributions and municipal bonds – although each will result in higher rates than a clean tax bill.

For the Center, the other key motivator is expanding employee-ownership. We propose to do that by including an NBRT deduction, to partially reduce income to Social Security, to purchase employer voting stock, with each employee receiving the same contribution, regardless of salary or wage level. In short order, employees will have the leverage to systematically insist on better terms, including forcing CEO candidates to bid for their salaries in open auction, with employee elections to settle ties.

Employee-ownership will also lead multi-national corporations to include its overseas subsidiaries in their ownership structure, while assuring that overseas and domestic workers have the same standard of living. This will lead to both the right type of international economic development and eventually more multinationalism.

Simultaneously, the high income and inheritance surtax will be dedicated to funding overseas military and naval sea deployments, net interest payments (rather than rolling them over), refunding the Social Security Trust Fund and paying down the debt.

Both employee-ownership with CEO pay reduction and paying off the debt will lead to two things – less pressure to deploy U.S. forces overseas and sunset of the income tax.

Military spending both overseas and domestic will decline under this plan. The VAT will make domestic military spending less attractive and overseas spending on deployments will be fought by income taxpayers, who are currently profiteering from such expenses. Instead, defense spending can shift to space exploration, which also increases invention and economic growth while keeping the defense industrial complex healthy, although now they can pursue profitable enterprises rather than lethality.

In short, our plan promises both peace and prosperity, not for the few but for the many. Prosperity bubbles up. It has never flowed down and tax reform should reflect that.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Contact Sheet

Michael Bindner
Center for Fiscal Equity
237 Hannes Street
Silver Spring, MD 20901
240-641-4617
fiscalequitycenter@yahoo.com

**Subcommittee on Tax Policy
Hearing on Perspectives on the Need for Tax Reform
Wednesday, May 25, 2016, 2:00 P.M.**

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.



May 24, 2016

Dear Members of the House Ways and Means Tax Policy Subcommittee:

The Coalition for Fair Effective Tax Rates congratulates you for holding this week's hearing about Perspectives on the Need for Tax Reform. We are eager to work with you to overhaul the U.S. Tax Code. As you collect views on this important topic, we urge you to place comprehensive tax reform among your top priorities.

The Coalition believes that a comprehensive approach must be taken to fix our broken federal income tax code. The tax system needs to be simplified and the tax base should be broadened. In addition, tax rates should be lowered both for corporations and for the vast majority of businesses that pay taxes through the individual rate system.

Indeed, true reform must address tax laws that impact both corporations and "pass-through" entities that pay taxes using individual rates. Repairing the tax system of one without the other would be woefully incomplete.

The current Tax Code is needlessly complicated and unfair. Large disparities exist between industries in the amount of taxes they pay – their effective tax rates. Our Coalition believes that tax reform should be viewed through the lens of effective tax rates. Successful reform should be measured by lawmakers' ability to reduce these discrepancies and create a more level playing field for businesses of all sizes across all industry sectors.

The disparity in effective tax rates paid by different U.S. industries is huge. According to the U.S. Treasury, effective actual federal corporate tax rates paid between 2007 and 2010 ranged from 30.3 percent by construction firms, 29.4 percent by services companies and 27.9 percent by wholesaler-distributors and retailers to 17.7 percent by leasing companies and 14.5 percent by utilities. The gap is simply unfair.

The Coalition for Fair Effective Tax Rates is a diverse group of national, regional and state associations representing more than 1,500,000 businesses, large and small, that support comprehensive tax reform. The importance of lowering tax rates for both corporations and pass through entities while also reducing disparities in effective tax rates is what binds us together.

Thank you in advance for pressing forward with tax reform and remembering to keep your focus on effective tax rates, the amount businesses actually pay in taxes.



**COALITION FOR FAIR
EFFECTIVE TAX RATES**

We look forward to working with you to develop and eventually approve comprehensive tax reform.

Sincerely,

Management Committee, Coalition for Fair Effective Tax Rates:

Retail Industry Leaders Association, Chair

Associated Builders & Contractors

Associated General Contractors

International Foodservice Distributors Association

International Franchise Association

National Association of Wholesaler-Distributors

Small Business and Entrepreneurship Council

About the Coalition for Fair Effective Tax Rates:

The Coalition for Fair Effective Tax Rates is a diverse group of national, regional and state associations representing more than 1,500,000 businesses, both large and small, whose mission is to educate Congress and key stakeholders that tax reform should be viewed through the lens of effective tax rates, the amount of taxes businesses actually pay. The Coalition intends to use the metric of effective tax rates to bolster the case for comprehensive tax reform that broadens the tax base while lowering tax rates for corporations and pass-through businesses that pay taxes using individual tax rates. More information about the coalition is available at <http://www.faireffectivetaxrates.com/>.

A list of the Coalition members is attached to this letter.



COALITION FOR FAIR EFFECTIVE TAX RATES

NATIONAL ORGANIZATION MEMBERS

American Apparel & Footwear Association
American Council of Engineering Companies
American Lighting Association
American Rental Association
American Subcontractors Association, Inc.
American Supply Association
American Trucking Associations
American Veterinary Distributors Association
Asian American Hotel Owners Association
Associated Builders & Contractors
Associated Equipment Distributors
Associated General Contractors
Association for Hose & Accessories Distribution (The)
Association of Pool & Spa Professionals
Auto Care Association
Business Solutions Association
Construction Financial Management Association
Convenience Distribution Association
Education Market Association
Equipment Marketing & Distribution Association
Food Industry Suppliers Association
Food Marketing Institute
Foodservice Equipment Distributors Association
FPDA Motion & Control Network
Gases and Welding Distributors Association
Health Industry Distributors Association
Healthcare Distribution Management Association
Heating, Airconditioning & Refrigeration Distributors International
Independent Electrical Contractors
Independent Insurance Agents & Brokers of America
Independent Office Products & Furniture Dealers Association
Industrial Supply Association

**COALITION FOR FAIR
EFFECTIVE TAX RATES**

International Association of Plastics Distribution
International Foodservice Distributors Association
International Franchise Association
International Pizza Hut Franchisee Association
International Warehouse Logistics Association
Irrigation Association
ISSA-The Worldwide Cleaning Industry Association
Material Handling Equipment Distributors Association
Metals Service Center Institute
Motorcycle Industry Council
National Association of Chemical Distributors
National Association of Electrical Distributors
National Association of Wholesaler-Distributors
National Beer Wholesalers Association
National Community Pharmacists Association
National Confectioners Association
National Electrical Contractors Association
National Funeral Directors Association
National Grocers Association
National Insulation Association
National Marine Distributors Association
National Restaurant Association
National Roofing Contractors Association
North American Equipment Dealers Association
NPES-The Association for Suppliers of Printing, Publishing and Converting Technologies
Outdoor Power Equipment & Engine Service Association
Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association
Printing Industries of America
Retail Industry Leaders Association
S Corporation Association
Secondary Materials and Recycled Textiles Association
Security Hardware Distributors Association
Small Business and Entrepreneurship Council
Taco Bell Franchise Management Advisory Council
Textile Care Allied Trades Association
Truck Renting and Leasing Association
Water & Sewer Distributors of America
Wholesale Florist & Florist Supplier Association



**COALITION FOR FAIR
EFFECTIVE TAX RATES**

Woodworking Machinery Industry Association
World Millwork Alliance





May 25, 2016

The Honorable Kevin Brady
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
U.S. House of Representatives
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Levin,

On behalf of the Computing Technology Industry Association (CompTIA), I would like to applaud your ongoing effort to reform our corporate tax system.

CompTIA is a non-profit trade association serving as the voice of the information technology industry. With approximately 2,000 member companies, 3,000 academic and training partners and nearly 2 million IT certifications issued, CompTIA is dedicated to advancing industry growth through educational programs, market research, networking events, professional certifications and public policy advocacy.

Our system of corporate taxation puts U.S. companies at a competitive disadvantage with their global competitors and is in urgent need of an overhaul. The last major tax reform occurred in 1986. On behalf of our membership, we will work to ensure that any corporate tax reform proposals treat the technology industry equitably – both large companies, as well as small and medium-sized businesses. Specifically, CompTIA recommends the following issues be included in comprehensive corporate tax reform:

1. Lower Corporate Tax Rate. U.S. companies are burdened with a corporate tax rate that is the highest among OECD (Organization for Economic Co-operation and Development) countries. The U.S. corporate tax rate is 39.2 percent, which is the highest in the industrialized world. This tax rate makes U.S. companies less competitive globally. CompTIA supports lowering the corporate tax rate to 25%, without increasing taxes on small and medium-sized businesses.

2. Territoriality. Currently the U.S. is one of the few developed countries that taxes corporate earnings on a global basis. This means that a U.S. company's foreign earnings are subject to U.S. tax when repatriated. Of the few countries that maintain a territorial tax system, the U.S. corporate tax rate is more than 50% higher (39.2%) than the next ranking country (24.2%). CompTIA supports enactment of a territorial international tax system that removes this punitive tax that effectively prevents foreign earnings from being repatriated to the United States.

515 2nd St., N.E. Washington, DC 20002

www.comptia.org



Page 2

3. Intellectual Property. CompTIA supports tax policy that fosters innovation such as a "innovation box" to attract and retain domestic IP development and ownership. In 2015, Reps. Boustany (R-LA) and Congressman Neal (D-MA) released a discussion draft of innovation box legislation designed to attract and retain R&D and IP in the United States. Under that proposal, "Innovation Box Profits" would be taxed at about 10%, as opposed to the regular corporate tax rate of 35%.

4. CFC Look-through Rule. Currently, the Internal Revenue Code requires that U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") include certain income of the CFC on a current basis for U.S. tax purposes, regardless of whether the income is distributed to shareholders. The territoriality provisions of most other developed countries allow companies to structure their foreign operations without the additional home country tax of the sort imposed by the U.S. Subpart F rules. CompTIA supports making the CFC look-through rule permanent in order to allow U.S. based companies to marshal their capital outside the United States in a way that would enable them to compete on a more level playing field with foreign competitors.

5. Repatriation of Profits. CompTIA supports legislation that would incentivize U.S. based companies to bring profits back into the U.S., by allowing those repatriated profits to be taxed at a lower tax rate. This influx of capital back into the U.S. could be used for capital investment to create technology advancement and job growth. Currently, companies are discouraged from bringing profits back into the U.S. because of the high corporate tax rate that would result. Repatriation of profits would encourage U.S. multinational corporations to return offshore profits, which nearly doubled between 2008 and 2013 to more than \$2.1 trillion.

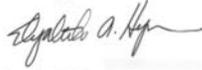
CompTIA.

Page 3

CompTIA believes that a competitive tax policy is critical for American technology companies to thrive in the U.S. and internationally, with lower corporate tax rates and movement to a territorial tax system. Accordingly, we urge you to work to restructure our outdated and overly complex federal tax code to provide a level playing field for the tech industry in both domestic and international tax issues.

We look forward to working with you and your staff as your tax reform plan is developed, and we stand ready to provide any assistance to further this goal.

Sincerely,



Elizabeth Hyman, Executive Vice President
CompTIA



October 31, 2016

Re: Hearing on Perspectives on the Need for Tax Reform**Subject: The moral imperative to abolish Citizenship Based Taxation**Summary of key points

- The United States is the only country besides Eritria to use CBT as opposed to RBT or source. This means that if you are a US citizen you must file and report your worldwide income to the US regardless of where you actually live. An RBT based system only requires people who are resident of a country to pay tax on their worldwide income to that country.
- CBT can have some very serious consequences especially for "Accidental Americans". Accidental Americans are people who live overseas who are US citizens because of being born in the US or because they were born to US citizen parents overseas, but have no emotional ties to the United States. Many don't see themselves as US citizens, or do not even know they are US citizens under US law. Many have never lived in the US or left when they were very young. Regardless of their lack of ties to the United States, they are legally required under US law to file and report their worldwide income.
- US citizens abroad must be careful with how they invest their money. A US citizen living overseas who invests their money in mutual funds in their country of residence, will face US taxation under rules of Passive Foreign Investment Companies (PFIC). These are rules designed to wipe out any meaningful investment in foreign mutual funds.
- US citizens have restricted options for investing for retirement. US citizens have to be careful with using Foreign retirement accounts because unless there is a tax treaty to exempt retirement accounts (as in the case of Canada or the UK) or the funds account can be treated as an employee benefits trust, then it is likely that the fund could be treated as a foreign grantor trust, and subject to full taxation on the growth of the fund each year, and subject to erroneous reporting requirements.
- Forcing people to renounce is unfair because the cost of renouncing is astronomical. A person seeking to renounce their citizenship must pay at least \$2350 to renounce. In many cases the exit tax may also apply. US citizens living abroad are not necessarily that wealthy, especially those who are "Accidental Americans" or second generation Americans abroad, and US citizens

who have lived abroad for many years should have the right to return to the US in light of unforeseen circumstances. This is not possible if they renounce.

- With the repeal of CBT, there would also be no need for FATCA as the US could rely on the Common Reporting Standard (CRS) made by the OECD as it would get the same information about US residents.

To whom it may concern,

I write to you to put my case for the moral imperative for the United States to abolish Citizenship Based Taxation (CBT) and replaced with Residence Based Taxation (RBT) as part of the US tax reform agenda.

I write to you as a United States citizen who was born and raised abroad, but nonetheless has strong emotional ties to the United States. The current CBT system forces me to reconsider my ties to the United States.

Firstly, let me lay out the facts. The United States is the only country besides Eretria to use CBT as opposed to RBT or source. This means that if you are a US citizen you must file and report your worldwide income to the US regardless of where you actually live. An RBT based system only requires people who are resident of a country to pay tax on their worldwide income to that country. If a citizen leaves then they will not be taxed on their worldwide income. For example an Australian citizen in Australia will be taxed on their worldwide income as an Australian resident. If that Australian citizen moved to the United States, they would no longer be taxed on their worldwide income by Australia, regardless of their citizenship. They would however be taxed on Australian sourced income. This would be no different to Australia taxing a US citizen in the US on Australian sourced income.

CBT can have some very serious consequences especially for "Accidental Americans". Accidental Americans are people who live overseas who are US citizens because of being born in the US or because they were born to US citizen parents overseas, but have no emotional ties to the United States. Many don't see themselves as US citizens, or do not even know they are US citizens under US law. Many have

never lived in the US or left when they were very young. Regardless of their lack of ties to the United States, they are legally required under US law to file and report their worldwide income. Theoretically its possible for someone to be subject to US taxation on their worldwide income without ever stepping foot in the United States. This is the reason why I argue there is a moral imperative to abolish CBT.

To give further justification for the moral imperative to abolish CBT, allow me to highlight the complexity of making financial decisions for US citizens living abroad. Firstly, US citizens aboard must be careful with how they invest their money. A US citizen living overseas who invests their money in mutual funds in their country of residence, will face US taxation under rules of Passive Foreign Investment Companies (PFIC). These are rules designed to wipe out any meaningful investment in foreign mutual funds.

Secondly, US citizens have restricted options for investing for retirement. US citizens have to be careful with using Foreign retirement accounts because unless there is a tax treaty to exempt retirement accounts (as in the case of Canada or the UK) or the funds account can be treated as an employee benefits trust, then it is likely that the fund could be treated as a foreign grantor trust, and subject to full taxation on the growth of the fund each year, and subject to erroneous reporting requirements. Placing retirement savings in the US may not be the answer because, other countries may not recognize US 401 k's or IRA's either, and thus US plans could be subject to the tax rules of the US Citizens residents' country. Also in countries like Australia, retirement funds are compulsory under law.

Many US citizens living abroad have taken to renouncing US citizenship as a method to solving this problem. I would argue this is unfair. Firstly, the cost of renouncing is astronomical. A person seeking to renounce their citizenship must pay at least \$2350 to renounce. In many cases the exit tax may also apply. US citizens living abroad are not necessarily that wealthy, especially those who are "Accidental Americans" or second generation Americans abroad. Many are working class, living paycheck to paycheck, and simply can't afford this fee. Also why should someone who became a US citizen by

circumstance of place of birth, or by circumstance of their parent's nationality and has lived abroad their entire life have to go through such a costly process to fix something that was of no fault of their own making?

Secondly, US citizens who have lived abroad for many years should have the right to return to the US. There are many reasons as to why a US citizen may chose to leave the US and go overseas. The two biggest would be a work opportunity that requires a US citizen to move overseas, or marrying someone from another country and choosing to live in that country as opposed to the US. The reality is unforeseen situations may occur, the job opportunity may cease, or the marriage may fall apart. In such cases it may be best for that US citizen to return home to rebuild their life. This is not possible if a US Citizen had to renounce because of US tax laws. US citizenship for a person living abroad should be treated as the right for that person to return, not as a tax liability.

In the past many US citizens living abroad were unaware of their US filing requirements. This should be understandable as RBT is the dominate system used throughout the world. Now however, with the Foreign Account Tax Compliance Act (FATCA), many Americans abroad are slowly learning their US tax obligations. The cost of coming into compliance because of taxes, penalties, and interest can be potentially life altering. FATCA is an extremely unfair law because of the sudden burden it places on people who have simply been unaware of their requirements. With the repeal of CBT, there would also be no need for FATCA as the US could rely on the Common Reporting Standard (CRS) made by the OECD as it would get the same information about US residents.

I hope you will consider the issues I have raised here as part of any reform to the US tax code.



Statement of the New Markets Tax Credit Coalition**Subcommittee on Tax Policy****Member Proposals for Tax Legislation****May 23, 2016**

My name is Robert Davenport and I am the President of the National Development Council (NDC). Focusing on Homes, Jobs and Community, NDC was founded as a national nonprofit in 1969 to create economic opportunity in America's low income communities. NDC invests capital to support the development and preservation of affordable housing, the creation of jobs through training and small business lending and the advancement of livable communities through investment in social infrastructure. Through its subsidiary, the NDC Housing and Economic Development Corporation (HEDC), NDC has made more than 90 loans and investments using the New Markets Tax Credit. This financing has revitalized economically distressed urban neighborhood and rural communities, creating jobs and business opportunities and improving industrial, commercial and community facilities.

I also serve as the President of The New Markets Tax Credit Coalition, a national membership organization with more than 150 community development organizations, financial institutions and public officials that advocates and supports the New Market Tax Credit. The Coalition is pleased to submit this statement in support of the New Markets Tax Credit and to indicate strong support for H.R. 855, *The New Markets Tax Credit Extension Act of 2015*, sponsored by Reps. Tiberi, Neal, Reed and 62 other Members of the House from both parties.

H.R. 855 does three things:

- Provides an indefinite extension of the New Markets Tax Credit (NMTC);
- Provides an increase in the annual NMTC allocation and indexes the allocation to inflation in future years; and
- Provides Alternative Minimum Tax (AMT) relief for NMTC investments thereby ensuring NMTC investors the same consideration under the AMT as is currently provided to investors in many other federal tax credits.

The NMTC was originally authorized in the *Community Renewal Tax Relief Act of 2000* (P.L. 106-554) as part of a bipartisan effort to stimulate investment and economic growth in low income urban neighborhoods and rural communities that lack access to the patient capital needed to support and grow businesses, create jobs, and sustain healthy local economies. That legislation authorized NMTC for 2001-2007 and made \$15 billion in annual credit authority available. Since that time, Congress has extended the NMTC several times:

- An additional \$1 billion was authorized for communities hard-hit by Gulf Coast hurricanes, *Gulf Opportunity Zone Act of 2005* (P.L. 109-135);
- In 2006, Congress extended the NMTC for 2008 at \$3.5 billion in annual credit authority through the *Tax Relief and Health Care Act of 2006* (P.L. 109-432);
- The *Emergency Economic Stabilization Act of 2008* (P.L. 110-343) extended the Credit for 2009, again at \$3.5 billion in annual credit authority;
- The *American Recovery and Reinvestment Act of 2009* (P.L. 111-16), increased credit authority to \$5 billion for both 2008 and 2009;
- The *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010* (P.L. 111-312) provided a two-year extension of the NMTC (2010 and 2011) with annual credit authority of \$3.5 billion;
- The *American Taxpayer Relief Act of 2012* (P.L. 112-240) provided a two-year extension of the NMTC (2012 and 2013) with annual credit authority of \$3.5 billion; and
- The *Tax Increase Prevention Act of 2014* (P.L. 113-295) extended the NMTC for 2014 at \$3.5 billion in annual credit authority.

Most recently, the *PATH Act* (P.L. 114-113) extended the NMTC for five years, from 2015 to 2019, at \$3.5 billion in annual credit authority. The *PATH Act* was the longest authorization for the NMTC since the *Community Renewal Tax Relief Act* and, at \$17.5 billion, the largest in the history of the Credit.

The NMTC program works by attracting capital to eligible communities by providing private investors with a modest federal tax credit for investments made in businesses or economic development projects located in some of the most distressed communities in the nation – 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’s median income. NMTC investors receive a tax credit equal to 39 percent of the total Qualified Equity Investment made in a Community Development Entity with the Credit, realized over a seven-year period. This amounts to 5 percent annually for the first three years, and 6 percent in years four through seven. Returns on NMTC investments are taxable, so the cost of each dollar of NMTC allocation to the federal government is not 39 cents, but rather, 26 cents.

The basis for the NMTC is that businesses’ success depends on access to capital. There are attractive investment opportunities in low income communities, but the cost and availability of capital in these ‘New Markets’ is an impediment to economic growth. Investors and firms often lack sufficient data to assess property value or consumer demand in low income communities, where informal economies distort data. The capital gap deprives businesses of the investment dollars they need to set up shop and expand. It impedes the construction or renovation of community facilities and revitalized industrial

and commercial facilities that would create jobs, economic opportunity and improve the quality of life.

Fifteen years after the NMTC's inception, the need for patient, flexible capital is as great as ever in low and moderate income rural, urban, and native areas underserved by commercial lenders.

A 2011 study by the Initiative for a Competitive Inner City found that "firms in low income census tracts received 21 percent fewer loans than would be expected, based on the number of firms in the tracts," even with a healthy demand for capital and an untapped consumer base. As a result, inner city neighborhoods are under-retailed, forcing residents to leave their neighborhoods to shop.

Small towns and farming communities also continue to be underserved by conventional lenders. A 2013 analysis by the Federal Financial Institutions Examination Council found that while rural low income census tracts include about 6 percent of the population and about 6 percent of the businesses, they only received around 5 percent of the loans and about 6 percent of the total dollar amount of small business loans in 2012. The decade's long trend of community bank closure and consolidation has hit rural areas particularly hard. The number of community banks in the United States has declined by an average of 300 per year over the past 30 years, according to data from the Federal Deposit Insurance Corporation.

The Office of the Controller of Currency found that residents of Indian Country¹ face challenges securing commercial credit, including "limited access to brick-and-mortar offices of regulated financial institutions; the perception by tribal business enterprises, even those with adequate collateral and good credit histories, that commercial bank financing is difficult to secure; a lack of diversity in funding sources; a lack of equity resources, collateral, and credit history, resulting in commercial credit denials for Indian small business owners."

The NMTC has a strong and proven track record in meeting the capital needs of these communities. Between 2003 and 2014, \$38 billion² in direct NMTC investments were made in businesses. In turn, these NMTC investments leveraged nearly \$75 billion³ in total capital investment to businesses and revitalization projects in communities with high rates of poverty and unemployment. By law, all NMTC investments must be made in economically distressed communities. However, more than 72 percent of all NMTC investments have been in communities exhibiting severe economic distress, including unemployment rates

¹ Commercial Lending in Indian Country: Potential Opportunities in a Growing Market", the Office of the Controller of Currency, February 2016

² CDFI Fund's FY 2015 Agency Financial Report

³ NMTC Coalition Estimate

more than 1.5 times the national average, a poverty rate of 30 percent or more, or a median income at or below 60 percent of the area median.

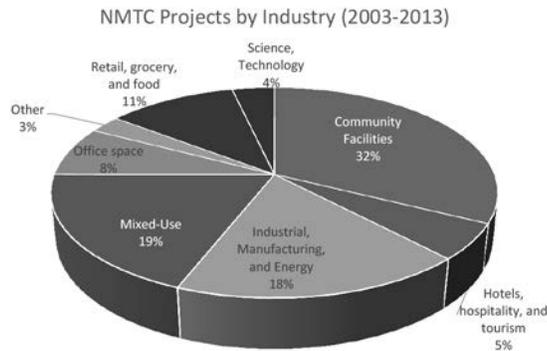
Between 2003 and 2012, the NMTC generated about 750,000 jobs⁴, at a cost to the federal government of less than \$20,000 per job. The New Markets Tax Credit generates economic activity, providing a return on investment to the federal government. In 2012, NMTC-financed businesses generated \$984 million in federal tax revenue which more than covered the estimated \$800 million cost of the Credit in terms of lost tax revenue in 2012. In addition in 2012, NMTC investments nationwide generated \$542 million in state and local tax revenue.

Beyond creating jobs and generating economic activity, the NMTC helps enhance community revitalization efforts by financing community facilities and other important quality of life amenities. Between 2003 and 2013, more than 1,300 NMTC projects involved community amenities like healthcare facilities, schools, nonprofit service providers, and childcare centers. A recent Urban Institute study examined the extent to which the NMTC helps communities add amenities, improve services, and finance community facilities. The study found that 88 percent of NMTC projects brought direct or indirect quality-of-life improvements to their communities, including parks, playgrounds, shopping centers, health clinics, and other amenities.

From business expansions to new healthcare and childcare facilities, the program was designed as a flexible incentive for economic development that meets evolving community needs. Instead of Washington picking winners and losers, the New Markets Tax Credit empowers local decision-making on important economic development projects. The nonprofit and industry sectors receiving NMTC financing are diverse, reflecting a cross-section of the American economy.

Nearly one-third of NMTC projects involve healthcare facilities, affordable space for innovative nonprofits and social enterprises, educational facilities, and other amenities that directly improve the quality of life for local residents. Another popular use of the NMTC is to finance facilities and/or equipment for industrial, manufacturing, and energy production firms. Approximately 20 percent of NMTC projects involve industrial activity. (See Chart below).

⁴ A Decade of the NMTC (2003-2012), NMTC Coalition (December 2014).



The New Markets Tax Credit is unique in its targeting and purpose. The NMTC is the only federal incentive that is primarily intended to drive capital to credit-starved businesses in economically distressed urban and rural communities, accounting for about 8 percent of annual tax expenditures for community development⁵. Unlike other programs that address a policy concern (such as affordable housing) that may overlap with low income communities, the NMTC provides both (1) the flexibility to finance a variety of businesses and projects in these low income communities along with (2) an effective established system to deliver that financing.

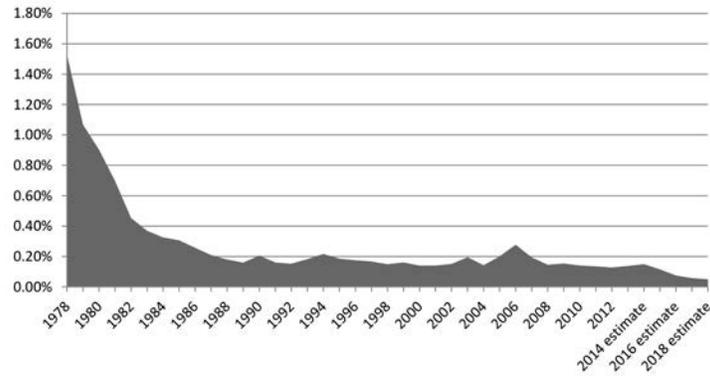
NMTC projects vary widely in size and scope – from a microloan fund in Portland Oregon that makes \$5,000 loans to minority entrepreneurs in low income neighborhoods, to the financing of a hospital in the GO Zone in Louisiana and a healthcare center in a very poor city in Massachusetts, to a tire factory in rural South Carolina, which created 1,600 permanent jobs in a county with an unemployment rate of 12.1 percent. Yet, all produce the same impact: better lives, communities and opportunity for urban neighborhood and rural communities that are left of the economic mainstream.

Because of reductions in federal spending, tax expenditures for community development are an increasingly important element in the federal support for housing as well as economic and community development. According to data from OMB, as measured as percentage of GDP, federal spending for community development – HUD, Agriculture, Commerce, and Interior -- has fallen by 75 percent since 1980⁶. (See Chart below).

⁵ The NMTC cost the federal government about \$1 billion in forgone revenue in 2014. In total, tax expenditures for community development amounted to \$12.035 billion.

⁶ OMB Historical Tables.

Federal Community and Regional Economic Development Outlays as a Percentage of GDP



Intense competition for Credits and a demonstrated record of success in placing Credit where the need and impact is greatest has increased the efficiency of NMTC. Over the history of the program demand for Credits has vastly outstripped the amount authorized. Treasury made the first NMTC allocation in 2003. Between 2003 and 2015, Treasury has received allocation applications for \$314.7 billion and has had just \$50.6 billion in NMTC allocation available.

The allocation application includes questions related to prior performance of the applicant, including how past NMTC use benefited low income businesses and distressed communities. The application requires applicants to quantify outcomes for previous loans and investments. If CDEs cannot demonstrate they used NMTC financing to maximize tangible outcomes and impacts in communities, they will be at a disadvantage in the intense competition for Credits.

The NMTC "but-for" test limits the amount of NMTC-generating financing necessary for financial feasibility. The NMTC typically provides "last-in" gap financing, meaning it is the last financing secured to make a project viable. CDEs and investors evaluate the sources and uses of available capital, the business plan of the enterprise in question, and its impact on the low income community in order to determine how much NMTC financing is needed to complete the project and maximize community impact.

If additional subsidies are not needed, the project will not receive NMTC financing. The NMTC is a scarce resource, which CDEs deploy accordingly. CDEs have no incentive to provide more NMTC-backed financing than what is absolutely necessary to make a project viable. Only after all the financing from other sources is committed, and the impact is clear, does a CDE commit to provide NMTC financing.

Under the law, CDEs are required to invest at least 85 percent of Qualified Equity Investments (QEIs) into projects. According to the GAO's survey for 2011-2012⁷, fees and retentions only totaled 7.1 percent of total NMTC Qualified Equity Investments (QEIs). The Urban Institute's Evaluation of the NMTC indicated that CDEs invested 97 percent of QEIs into businesses and projects⁸. In other words, the two most recent reports on NMTC indicate that investment rates are well above the requirements established in law and regulation.

Broadening the NMTC investor base would increase competition and efficiency, leading to better pricing, and driving even more subsidy to businesses operating in NMTC-qualified communities. By enacting H.R. 855 Congress can take steps to increase the NMTC's efficiency. The real obstacles to greater efficiency are the lack of a longer time horizon for the program and an exemption from the Alternative Minimum Tax (AMT) for New Markets investments. A long term or permanent authorization will provide investors and CDEs more time to plan and invest in the infrastructure necessary to support the program.

Exemption from the AMT would diversify the pool of investors who could invest in the NMTC. Unlike other investment tax credits, including the Low Income Housing Tax Credit (LIHTC) and the Historic Tax Credit (HTC), NMTC investments are subject to the AMT. Providing an AMT exemption for NMTC investments would bring the NMTC in line with those other credits and open up the NMTC investor market to new investors, including community banks and corporate investors who are currently restrained by AMT.

It is time to expand and make the New Markets Tax Credit permanent. The NMTC meets an important and critical need for private-sector investment in economically distressed urban and rural communities. It blends the market incentive of Jack Kemp's Enterprise Zones with the flexible community-driven approach of Lyndon Johnson's Economic Opportunity Act. Furthermore, data on the impact of the NMTC shows that it has not only achieved its purpose, but it has done so at a relatively low cost to the federal government, particularly when compared to traditional economic development grant programs. Perhaps most importantly, these investments drive and attract additional and new investments to the community, creating a ripple effect of economic development in some of the poorest and hardest hit areas in America. With dwindling government resources, the priority should be given to programs that achieve their purpose efficiently, and the NMTC hits the mark.

⁷ GAO-14-500: Published: Jul 10, 2014.

⁸ Urban Institute Evaluation of the NMTC: June 2013.

Testimony to the House Ways and Means Committee
Submitted for the Record by
National Rural Electric Cooperative Association
May 25, 2016

National Rural Electric Cooperative Association (NRECA) is the national service organization for America's Electric Cooperatives. The nation's member-owned, not-for-profit electric cooperatives constitute a unique sector of the electric utility industry – and face a unique set of challenges. NRECA represents the interests of the nation's more than 900 rural electric utilities responsible for keeping the lights on for more than 42 million people across 47 states. Electric cooperatives are driven by their purpose to power communities and empower their members to improve their quality of life. Affordable electricity is the lifeblood of the American economy, and for 75 years electric cooperatives have been proud of providing affordable, reliable, and accessible electric service in the communities they serve.

NRECA stands in strong support of HR 5167 "Technologies for Energy Security Act."

Many of our distribution electric cooperatives offer their members a way to save energy and money by promoting the use of geothermal heat pumps. According to a survey conducted in 2014 by our Business and Technology Strategies Group, over 40% of electric distribution cooperatives utilize geothermal heating/cooling pumps as part of their energy efficiencies programs. (Attachment 1)

These super-efficient systems can be scaled to any size, produce clean energy 24 hours per day and can cut utility bills by up to 70 percent. Our electric cooperative member-owners install geothermal systems utilizing the geothermal tax credit. Many of the electric distribution cooperatives throughout the US also provide additional incentives including energy rebates and on-bill financing for geothermal pumps. The tax credits for geothermal technologies for both residential and commercial purpose expire at the end of this year jeopardizing the continued implementation of this energy efficient technology. Electric cooperatives rely on this tax credit as an incentive to reduce the upfront costs and to encourage members to install geothermal heating systems and reduce their energy consumption.

At the end of last year Congress passed an omnibus appropriation bill which contained many tax provisions including phasing out or phasing down the solar tax credits in sections 25D and 48. Geothermal heat pumps, small wind property, and other technologies listed in the very same section of law were left out of the year end package. NRECA is seeking parity for the technologies that were orphaned last year giving them the same phase-out or phase down in these sections.

Under Section 48 (commercial tax credit) solar receives 30% tax credit. Starting in 2020, the value of the credit for solar decreases to 26% in 2020, then 22% in 2021, and is made permanent at 10%. Because the rest of Section 48 was not included in the yearend deal, the credit ends for geothermal heat pumps at the end of 2016. (Figure 1)

Under Section 25D (residential tax credit), both solar and geothermal receive the same 30% of the investment. However, solar was extended and phased-out the same way as it is phased-out under Sec. 48 (26% in 2020, 22% in 2021) but the credit then sunsets at the end of 2021. In a similar manner, the geothermal credit was not extended and ends at the end of 2016. (Figure 1)

Geothermal, Small Wind Turbines and other technologies were not given the same consideration as wind and solar at the end of last year. We are seeking tax parity for technologies that many of our members utilize. These tax credits go directly to our member/owners.

We thank the Ways and Means Committee for their consideration of HR 5167 which extends and phases out geothermal and other technologies in sections 25D and 48.

Attachment 1

Co-ops offering Ground Source Heat Pumps



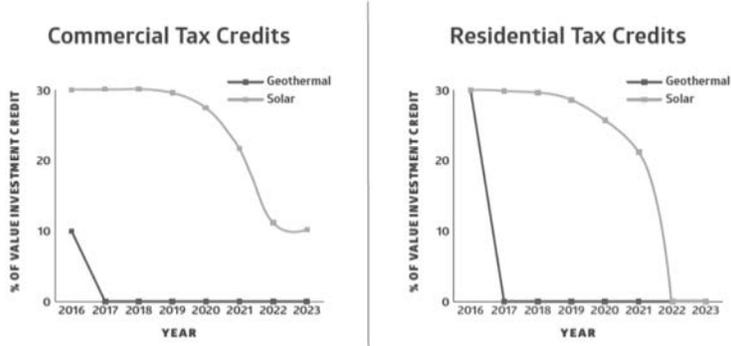
W11 March 2014

RTS Strategy & Economic Analysis
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Figure 1

Disparity Between Solar & Geothermal Tax Credits



The Honorable Charles Boustany
Chairman
Ways and Means Tax Policy Subcommittee
1431 Longworth House Office Building
United States House of Representatives
Washington, D.C. 20515

The Honorable Richard Neal
Ranking Member
Ways and Means Tax Policy Subcommittee
341 Cannon House Office Building
United States House of Representatives
Washington, D.C. 20515

May 24, 2016

Dear Chairman Boustany and Ranking Member Neal:

As the House Ways and Means Tax Policy Subcommittee considers proposals to improve the U.S. tax system, we strongly urge the adoption and enactment of the Master Limited Partnerships (MLP) Parity Act, H.R. 2883, introduced by Representatives Poe (R-TX-2) and Thompson (D-CA-5). The expansion of MLPs for the U.S. energy sector will enable greater parity in the tax code, encourage technology diversity, spur private investment, enhance national security, and protect the environment.

MLPs are investment vehicles taxed as partnerships but whose ownership interests trade like corporate stock. They provide access to large amounts of low-cost capital for traditional energy projects -- primarily oil and gas pipelines -- with a current market capitalization of more than *\$450 billion*. Bipartisan, bicameral legislation has been introduced in multiple sessions of Congress that would open up MLPs to a broader set of energy technologies from wind, solar, and storage to carbon capture, energy efficiency, and cogeneration.

Congress first authorized MLPs in 1987, limited primarily to fossil fuel-based resources. This has allowed companies to finance projects deploying the qualifying technologies at lower interest rates. However, clean and efficient energy companies are not allowed to utilize this effective financial instrument. Congress should expand MLPs to ensure a level playing field for a broader array of energy sources and technologies and expand investment opportunities for American investors.

We urge you to include, and support enactment of, the MLP Parity Act as part of any legislation aimed at improving the U.S. tax system.

Sincerely,

Advanced Biofuels Association
Advanced Energy Economy
AEC Science & Technology, LLC
Algae Biomass Organization
Alliance for Industrial Energy Efficiency
Alliance to Save Energy
Amazon
American Council of Engineering Companies
American Council on Renewable Energy
Biomass Power Association
Biomass Thermal Energy Council
Biotechnology Industry Organization
CERES
Combined Heat and Power Association
Energy Storage Association
Environmental and Energy Study Institute
First Solar
Geothermal Energy Association
Growth Energy
Heat is Power Association
High Performance Building Coalition
Illuminating Engineering Society of North America
International Code Council
International Facilities Management Association
Malachite LLC
National Association of State Energy Officials
National Electrical Manufacturers Association
Natural Resources Defense Council
R Street Institute
Sheet Metal and Air Conditioning Contractors' National Association
Solar Energy Industries Association
The Pew Charitable Trusts
Third Way
Union of Concerned Scientists