JOINT COMMITTEE ON TAXATION
April 26, 2016
JCX-36-16

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FINANCE HEARING ON NAVIGATING BUSINESS TAX REFORM[1]

APRIL 26, 2016

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

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

1. Does the tax system promote economic efficiency? That is, is the tax system neutral or does it create biases in favor of or against certain economic activities when compared to choices taxpayers would make in the absence of taxes?

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

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

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

2. Does the tax system promote economic growth? How does the tax system affect the potential for citizens to be better off in the future than they are today?

3. Is the tax system fair? Are similarly situated taxpayers treated similarly? Are tax burdens assessed recognizing that different taxpayers have different abilities to pay?

4. Is the tax system administrable for both the taxpayer and the Internal Revenue Service? Does the tax system minimize compliance costs for taxpayers and administrative costs of the tax administrator?

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

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

Base broadening to lower rates

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

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

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

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

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

[4] A tax expenditure calculation is not the same as a revenue estimate for the repeal of the tax expenditure provision. First, unlike revenue estimates, tax expenditure calculations do not incorporate the effects of the behavioral changes that are anticipated to occur in response to the repeal of a tax expenditure provision. Second, tax expenditure calculations are concerned with changes in the reported tax liabilities of taxpayers and may not reflect

Largest U.S. Corporate Tax Expenditures 2015-2019

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

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

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

- Tax Reform Act of 2014[5]
  a. Introduced in December 2014 by Mr. Camp (the then House Ways and Means Committee Chairman).
  b. Reduces corporate income tax rate to 25 percent.
  c. Changes depreciation rules.

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timing of tax payments. Third, the tax expenditure estimate includes only income tax effects and not interactions between income tax provisions and other Federal taxes. Fourth, the tax expenditure estimates reported here reflect provisions in Federal tax law enacted through September 30, 2015, and are based on the January 2015 Congressional Budget Office ("CBO") revenue baseline, while the revenue estimates reflect present law and the current CBO revenue baseline. Nevertheless the orders of magnitude of revenue loss are represented fairly.

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

i. Expands expensing permitted under section 179.

ii. Allows bonus depreciation to expire.

iii. Requires straight-line method of cost recovery over applicable recovery period.

iv. Makes available election to index basis to chained consumer price index for all urban consumers (“CPI-U”).

d. Requires amortization of 50 percent of advertising expenditures over 10 years.

e. Requires amortization of research and experimentation expenditures over five years.

f. Repeals last-in, first-out (“LIFO”) and lower of cost or market (“LCM”) methods of accounting.

g. Phases out section 199 domestic production activities deduction.

h. Proposes other base-broadening measures.

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

Maintaining parity between corporate and passthrough entities

More so than in a number of other countries, substantial business income in the United States is not subject to a separate entity level tax such as our corporate income tax but rather is passed through to an individual’s income tax return and taxed as part of the business owner’s individual income.[8] For example, in 2012, more than 40 percent of all business income reported

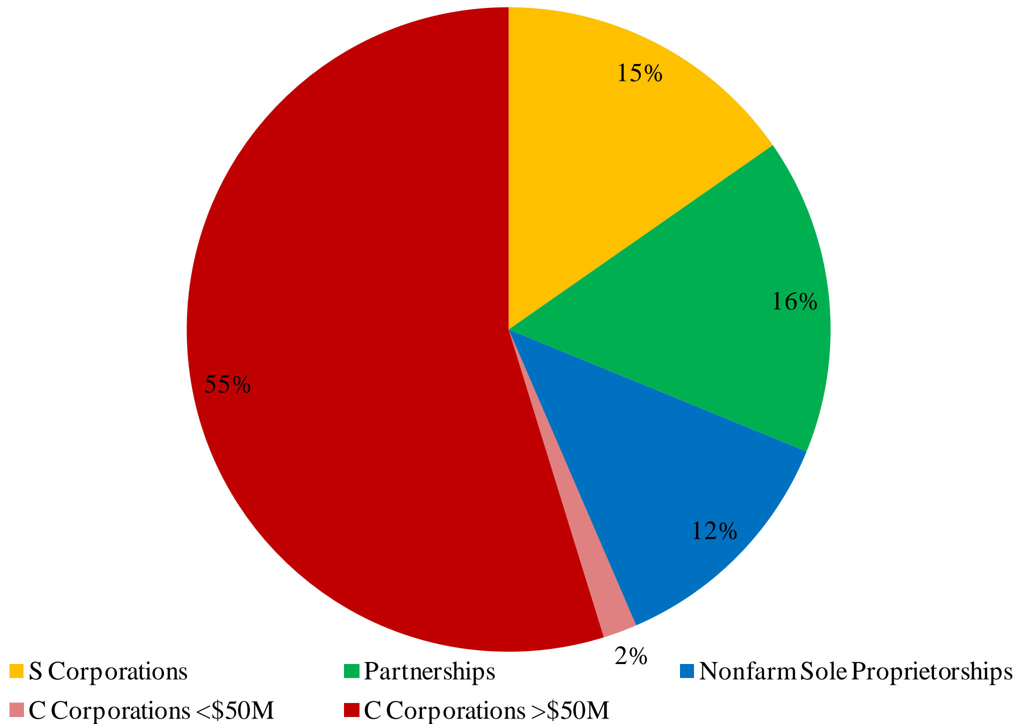
[6] See Nicholas Bull, Timothy A. Dowd, and Pamela Moomau, “Corporate Tax Reform: A Macroeconomic Perspective,” *National Tax Journal*, vol. 64, no. 4, December 2011, pp. 923-941.

[7] *Ibid.*

[8] In a study analyzing corporate and individual shares of net income from business activities in five countries, it was observed that “[t]he corporate share of net income from business operations was 81.9 percent in Australia, 74.5 percent in Canada, and 67.5 percent in the United Kingdom in 2009, while it was 34.1 percent in

in the United States was earned by S corporations, partnerships, and nonfarm sole proprietorships.[9]

Net Income by Business Form in 2012



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

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

Owners of C corporations generally bear two levels of tax that in total can exceed 50 percent. However, if the earnings of the C corporation are not distributed the current tax burden of those earnings is 35 percent or less. On the other hand, owners of passthrough entities

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Germany in 2007 and 43.8 percent in the United States in 2009. In 2010, roughly equal shares of business income were earned by corporations and individuals in Japan." Joint Committee on Taxation, *Foreign Passthrough Entity Use in Five Selected Countries*, October 2013, p. 11. This document is available on the Joint Committee on Taxation website at www.jct.gov.

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

generally do not bear a tax rate greater than 44 percent, but that rate of tax may apply regardless of whether the earnings of the entity are distributed or retained.

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

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

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

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

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

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

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

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

Corporate integration

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

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

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

income, or deduct, dividends received, or by providing shareholders with a credit equal to all or a portion of the corporate-level tax paid by the corporation.

Innovation

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

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

Other business income tax reform proposals

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

Navigating Business Tax Reform
Testimony of Thomas Barthold,
Chief of Staff, Joint Committee on Taxation

Prepared by the Staff of the Joint Committee on Taxation
April 26, 2016

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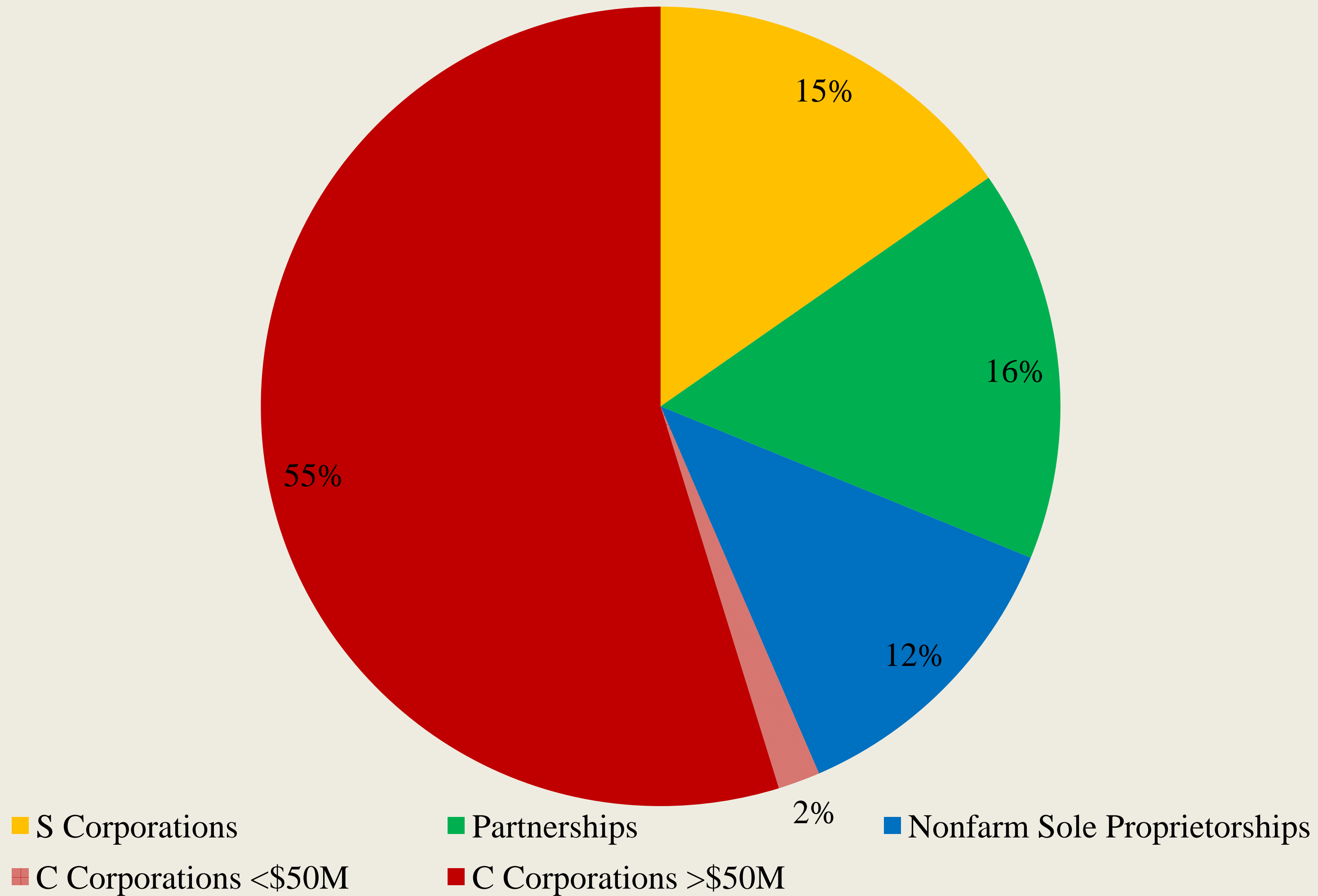

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Corporate Integration Approaches

- Some alternative approaches to integration of corporate and individual levels of tax on corporate income
  - "Full integration"- shareholder allocation method (treat corporate income like passthrough income)
  - Partial integration approaches ("dividend relief")
    - Corporation deducts dividends paid to shareholders
    - Tax on corporate income applies partially at shareholder level, corporation withholds tax on distributions
    - Reduced tax rate for shareholders on dividends received and gains on stock sale/exchange
    - Shareholders exclude from income (or deduct) dividends received
    - Shareholders get a tax credit for some corporate-level tax paid on distributed amounts

Features of Selected Tax Reform Proposals

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

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

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

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

Consumption Tax Proposals – FAIR Tax Act of 2015, introduced Jan. 13, 2015, by Senators Moran, Perdue, and Isakson (S. 155, 114th Congress)

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

Cost Recovery and Tax Accounting –

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

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

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

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