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ATR Feedback on the Chairman's Mark of the Tax Cuts and Jobs Act

November 13, 2017

Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch & Members of the Senate Finance Committee:

I write to offer feedback on the Chairman's mark of the Tax Cuts and Jobs Act. As a whole the plan is pro-growth and pro-family.

The Finance Committee should be congratulated for releasing this legislation as part of a multi-year regular order process that has included dozens of hearings.

On the individual side, this legislation gives tax cuts for Americans of all income levels and drastically simplifies the code. However, it is also important that tax reform fully repeals the death tax, and I urge you to ensure the legislation reported out of Committee does this.

On the business side, the plan is extremely pro-growth. I would like to highlight a number of issues that are important to ensuring the plan remains pro-growth:

- Ensuring pro-growth cost recovery with 100 percent expensing, an appropriate cap on deductibility of interest and preserving section 1031 and the deductibility of advertising;
- Ensuring the 20 percent corporate rate is permanent and immediate;
- Creating a globally competitive system of international taxation;
- Maintaining appropriate treatment of carried interest capital gains.

As the Senate Finance Committee begins markup of the Tax Cuts and Jobs Act, ATR stands ready to work with you to ensure passage of comprehensive tax reform in 2017.

If you have any questions, please contact ATR's Director of Tax Policy Alex Hendrie at 202-785-0266 or by email at ahendrie@atr.org.

Onward,

Grover Norquist
President, Americans for Tax Reform

Individual Tax Reform

Tax reform must reduce the tax burden on Americans of all income levels and must simplify the code. The Tax Cuts and Jobs Act achieves both of these goals.

Under this plan, a family of four earning $73,000 would see a tax cut of nearly $1,500 – a tax reduction of 40 percent. As noted by the distributional analysis conducted by the Joint Committee on Taxation, this tax reform plan would cut taxes for Americans of all income levels, with the biggest benefit going to the middle class.[1]

This plan also drastically reduces the number of taxpayers that itemize by doubling the standard deduction to $12,000 or $24,000 for a family. Based on some estimates, the number of filers that take the standard deduction will increase from roughly 66 percent of taxpayers to 90 or 95 percent of taxpayers. This also represents strong tax relief for the more than 105 million taxpayers that already take the standard deduction.[2]

Similarly, the plan consolidates existing child provisions and expands the Child Tax Credit to $1,650 per child. More than 22 million Americans used the child tax credit in 2015 and under the Tax Cuts and Jobs Act these families would see significant tax reduction and simplification.

The Tax Cuts and Jobs Act also proposes full repeal of the Alternative Minimum Tax, which hits almost 4.5 million taxpayers nationwide. Finally, the plan repeals numerous distortionary deductions and credits, such as the State and Local tax deduction which subsidizes high tax states at the expense of everyone else.

The individual reforms in the Tax Cuts and Jobs Act keep the promises made to simplify the tax code and reduce taxes for Americans of all income levels.

A Globally Competitive 20 Percent Corporate Rate

The U.S. has the highest marginal corporate income tax rate in the developed world. At 35 percent (plus an average state rate of 4 percent), the U.S. is nearly 15 points higher than the typical developed country which has a rate around 25 percent.

In the increasingly global economy, it is clear that workers are more vulnerable to the high U.S. corporate rate. A high corporate tax rate means that capital will be relocated in a more productive way (i.e. to a country with a lower corporate tax rate). In other words, U.S. capital is mobile, while U.S. workers are not.

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[1] Distribution Effects Of The Chairman's Mark Of The "Tax Cuts And Jobs Act," Scheduled For Markup By The Committee On Finance On November 13, 2017. (2017, November 11). Retrieved November 13, 2017, from https://www.jct.gov/publications.html?func=startdown&id=5035

[2] Hendrie, A. (2017, October 3). Who Benefits From Simplification Proposed in the Republican Tax Reform Framework? Retrieved November 11, 2017, from Who Benefits From Simplification Proposed in the Republican Tax Reform Framework

Recent studies[3] that take this into account by using an "open economy model" find that workers bear a significant portion of the corporate tax — 50 percent,[4] 70 percent,[5] or even higher.[6] This means a lower corporate rate directly correlates with more jobs and more take-home pay.

Importantly, the Tax Cuts and Jobs Act lowers the corporate rate to 20 percent, effective January 1, 2019. In a perfect world, this 20 percent rate would be effective 2018 to encourage stronger economic growth as quickly as possible. However, the plan is still extremely pro-growth especially considering the constraints faced by budget reconciliation and the many other provisions in the plan that will help the economy.

Cost Recovery/ Deductibility of Business Expenses

Moving to a System of Immediate Expensing: Under current law, businesses must deduct, or "depreciate" the cost of new investments over multiple years depending on the asset they purchase, as dictated by arbitrary IRS rules**.**

This system of depreciation creates complexity in the code and distorts economic decision making. Ideally, all business expenses (whether it is employee wages and benefits, rent, new investments or advertising) should be immediately deductible under the tax code.

The Tax Cuts and Jobs Act takes a huge step toward achieving this goal by implementing 100 percent expensing for five years. This increased incentive for investment will lead to stronger economic growth.

Preserving Existing Deductibility of Advertising: Advertising is one of many costs of doing business that firms are properly allowed to deduct under current law. As part of a move toward-immediate expensing of all investments, it is important that tax reform maintains the current tax treatment of advertising.

Both the House and Senate bill currently protect the deductibility of advertising. Moving forward, it is important that tax reform does not deviate from current law.

Maintaining 1031 for Certain Assets: Section 1031, also known as like-kind exchanges, is an important part of the tax code. This provision allows taxpayers to defer paying taxes on certain types of assets when they use those earnings to invest in another, similar asset. Sec. 1031 eliminates a potential barrier to investment, which in turn promotes the more efficient allocation of capital resources.[7]

A move toward full expensing of all new investments, as the Tax Cuts and Jobs Act proposes, will streamline business activity by allowing the efficient purchase of new assets. Sec. 1031 should be considered complimentary to this goal.

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[3] Entin, S. J. (2017, October 24). Labor Bears Much of the Cost of the Corporate Tax. Retrieved November 11, 2017, from https://taxfoundation.org/labor-bears-corporate-tax/

[4] Desai, M., Foley, C. F., & Hines, J., Jr. (2007, December). Labor and Capital Shares of the Corporate Tax Burden: International Evidence. Retrieved November 13, 2017, from http://www.people.hbs.edu/ffoley/labcapshr.pdf

[5] Randolph, W. (2006, August). International Burdens of the Corporate Income Tax. Retrieved November 12, 2017, from https://cbo.gov/sites/default/files/cbofiles/ftpdocs/75xx/doc7503/2006-09.pdf

[6] Arulampalam, W., Devereux, M., & Maffini, G. (2010, October). The Direct Incidence of Corporate Income Tax on Wages. Retrieved November 13, 2017, from http://ftp.iza.org/dp5293.pdf

[7] Hendrie, A. (2016, December 6). Like-kind Exchanges Should Be Preserved as Part of Any Tax Reform Plan. Retrieved November 12, 2017, from https://www.atr.org/kind-exchanges-should-be-preserved-part-any-tax-reform-plan

It is especially important to preserve Sec. 1031 for land, which typically does not benefit from full expensing. Because of the exclusion of land, repeal of like-kind exchanges – even with full expensing – may have the effect of impeding otherwise economically productive transactions.

Both the House and Senate bills meet this goal by maintaining Sec. 1031 for real property.

Employee Compensation: Versions of both the House and Senate bills have proposed elimination of the deductibility of deferred employee compensation, such as stock options. The proposal does not include a grandfathering clause, eliminating the deductibility of stock options that have already been granted but would vest following enactment.

This would remove an important way that businesses compensate employees, and (as currently written) would subject businesses to taxation based on past stock options granted.

Inevitably, tax reform requires tradeoffs. In many cases, this involves creating pay-fors that offset the revenue from lower marginal tax rates. These pay-fors need to be carefully considered so as not to undermine the pro-growth aspects of reform. One way to achieve this goal is to have reasonable transition rules and appropriate grandfathering of some provisions.

Ideally, full deductibility of employee compensation should be maintained. At a minimum, tax writers should ensure this change is grandfathered in so that past compensation granted is not taxed.

Retaining Reasonable Deductibility of Interest: As noted above, ATR believes that full business expensing, is an extremely important, pro-growth reform that must be included in tax reform. Often, moving to a system of expensing is tied to repeal of interest deductibility. However, full repeal of the deductibility of net interest expenses would be overly burdensome to many business models. Instead, tax writers should ensure that reasonable deductibility is maintained.

Both the House and Senate bills achieve this by including a reasonable limit on the deductibility of interest that is tied to business earnings. Lawmakers should also ensure that any limitation on the deductibility of interest is phased in a similar way to any phase-in of corporate tax reductions.

Treatment of Carried Interest Capital Gains

Taxes on capital gains and dividends are taxes on investment. Repealing or lowering the capital gains tax allows more money to be invested productively into the economy, which increases economic growth, creates more jobs, and leads to higher wages.

The standard for capital gains treatment is and always has been based around entrepreneurial investment in a capital asset, whether this is in the form of capital or labor or both. Tax reform will likely take aim at one type of capital gain – known as carried interest. Despite rhetoric from the left, carried interest capital gains income is simply the expert investor’s share of a partnership, and is no different from other types of capital gains income.

The House version of the Tax Cuts and Jobs Act contains a compromise on the treatment of carried interest between those who want to keep capital gains taxes low and those who support higher taxes on capital gains. This compromise increases the minimum hold period for access to long-term capital gains from one year to three years and is an acceptable compromise.

At a minimum the Senate bill should adopt this compromise. Certainly, the Chairman's mark should not extend this hold period beyond three years or further increase taxes on carried interest capital gains in other ways. Doing so would hinder economic growth and directly impact pension funds, charities, and colleges that depend on investment partnerships as part of their savings goals.

Full Repeal of the Death Tax

Tax reform should include full repeal of the death tax. While the Senate proposal to double the exemption threshold of the tax to $10 million is a step in the right direction, it is insufficient progress. Leaving the tax in place will mean families still have to plan around the tax.

The death tax hurts the economy, imposes undue burdens on taxpayers, and is extremely unpopular with the American people. The death tax is especially burdensome on family owned small businesses, the core of America's economy. This loss of capital ultimately results in fewer jobs and lower wages for American workers.[8] In fact, according to the Joint Economic Committee, the death tax has suppressed the creation of over $1.1 trillion of capital in the United States' economy since being introduced.[9]

According to research by the Tax Foundation, repeal of the death tax would create the equivalent of 159,000 full time jobs and increase long-run GDP by 0.8 percent.[10] The death tax is also extremely unpopular and a majority of Americans support its repeal. For example, a recent report by NPR found that 76 percent of Americans support full, permanent repeal of the death tax.[11]

International Tax Reform That Promotes American Competitiveness

The Tax Cuts and Jobs Act replaces the outdated worldwide system of taxation with a territorial system of taxation. This is a key reform, as 95 percent of consumers live outside the U.S. and a total of 41 million jobs are tied to business operations overseas. However, the U.S. is just one of six countries in the developed world that still uses the worldwide system of taxation.[12]

In practice, a territorial system of taxation requires base erosion rules to act as guardrails for the system. Base erosion rules must be carefully considered.[13] Overly burdensome rules that create too much of a burden on U.S. based taxpayers would only perpetuate the uncompetitive tax system. This means that any rules must be developed with an eye to the systems employed by the rest of the world. Countries commonly apply base erosion provisions in several ways:

-through providing rules governing taxation of CFCs;

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[8] Holtz-Eakin, D., & Smith, C. (2010, September). Growth Consequences of Estate Tax Reform: Impacts on Small and Family Businesses. Retrieved November 12, 2017, from http://policyandtaxationgroup.com/wp-content/uploads/2015/05/AFBF-Holtz-Eakin-Paper-2010.pdf

[9] Cost and Consequences of the Federal Estate Tax: An Update. (2012, July 25). Retrieved November 12, 2017, from http://www.jec.senate.gov/public/_cache/files/bc9424c1-8897-4dbd-b14c-a17c9c5380a3/costs-and-consequences-of-the-federal-estate-tax-july-25-2012.pdf

[10] Walczak, J. (2017, July 17). State Inheritance and Estate Taxes: Rates, Economic Implications, and the Return of Interstate Competition. Retrieved November 12, 2017, from https://taxfoundation.org/state-inheritance-estate-taxes-economic-implications/

[11] Kurtzleben, D. (2017, April 17). We Asked People What They Know About Taxes. See If You Know The Answers. Retrieved November 12, 2017, from http://www.npr.org/2017/04/17/523960808/we-asked-people-what-they-know-about-taxes-see-if-you-know-the-answers

[12] Pomerleau, K. (2015, February 5). Worldwide Taxation is Very Rare. Retrieved November 12, 2017, from https://taxfoundation.org/worldwide-taxation-very-rare/

[13] Hendrie, A., & Grady, O. (2017, October 30). Moving to a (Properly Designed) Territorial System of Taxation Will Make America's Tax System Internationally Competitive. Retrieved November 12, 2017, from https://www.atr.org/sites/default/files/assets/ATR%20paper%20on%20territorial%20tax.pdf

-providing rules around dividend exemption systems;

- limiting the deductibility of interest for CFCs.

On the other hand, countries typically do not impose taxation on CFC's active business income (income from goods and services of the business).

Instead, foreign countries have certain tests to ensure that the sale of goods and services, as well as payments on royalties and interest are properly taxed. The country then applies full corporate tax based on the outcome of these tests. In most cases, business activity should not be taxed if the income is being earned (and taxes paid) in a foreign jurisdiction.

As provisions are developed, it is key that they are based on international best practices.

For example, almost every country treats cross border financial transactions neutrally. This means that transactions are not subject to foreign base erosion provisions and are treated the same whether they are foreign or domestic transactions. This includes common financing transactions between different countries, but also payments based on reinsurance flows.

In the case of reinsurance, including these transactions in base erosion provisions would not only undermine the competitiveness of the U.S. international system, it would also harm the model of globally spreading risk that reinsurance relies on.[14]

In general, this also means that broad base erosion provisions, like a broad-based minimum tax, should be avoided because they risk punishing certain types of business activity that is not taxed by foreign competitors.

[14] Hendrie, A. (2016, October 26). Congress Should Not Use the Tax Code to Pick Winners and Losers in the Reinsurance Industry. Retrieved November 12, 2017, from https://www.atr.org/congress-should-not-use-tax-code-pick-winners-and-losers-reinsurance-industry