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Initial impressions of Finance Committee working groups' reports on tax reform

On July 8, The Senate Finance Committee circulated **reports** on tax reform from five bipartisan "working groups" composed of Finance Committee members. The working groups have been laboring since January 2015 to prepare tax reform policy options and recommendations for the full Senate Finance Committee to consider as part of comprehensive tax reform.

Each working group was tasked with studying one of five areas:

- International income tax
- Business income tax
- Savings and investment
- Individual income tax
- Community development and infrastructure

Overall, the final reports released today do not provide the full Finance Committee with specific tax reform policy recommendations. As explained in the report from the business income tax working group:

In producing this report, the intent of the working group was not to provide the committee a comprehensive, "approved" list of tax reform options that could be selected or disregarded unilaterally.

Instead, in many instances, the reports may serve as guides for the full Finance Committee in identifying the areas in which committee examination is most likely to result in bipartisan proposals. In so doing, the reports also suggest how difficult the Finance Committee's task will be in producing comprehensive tax reform.

The following discussion provides initial impressions of the working groups' reports.

International income tax

The U.S. international tax regime is "a system that is clearly broken" and that "reflects the realities of a different era" according to the report of the international tax working group.

Authored by the working group co-chairs, Senators Rob Portman (R-OH) and Charles Schumer (D-NY), the report concluded that the worldwide system of international taxation employed by the United States produces "a powerful incentive to make foreign, rather than domestic investments." This leaves U.S. companies at a competitive disadvantage relative to companies operating in other OECD countries with some form of territorial tax system. Ending the "lock-out" effect of the current worldwide system with deferral, the report says, is an important reform consideration.

The co-chairs therefore recommended, in very broad terms, the adoption of a dividend exemption or hybrid territorial tax system coupled with "robust and appropriate" base erosion rules. They refer, in particular, to versions of such a system outlined in the president's FY 2016 budget and in former Ways and Means Committee Chairman Dave Camp's proposals for international tax reform in the Tax Reform Act of 2014 (TRA 14). The working group's report notes that both the FY 2016 budget and TRA 14 would impose a minimum level of tax on foreign earnings of controlled foreign corporations (CFCs), indicating such a measure likely would be part of future consideration of reform.

Other issues identified for future consideration would include the appropriate cost allocation system or dividend exemption percentage (in the case of a dividend exemption system) and the appropriate treatment of foreign branches and S corporations.

Concern was expressed about the OECD base erosion and profit shifting (BEPS) project as well as unilateral actions taken by other OECD members with regard to taxation of intellectual property through so-called "innovation box" regimes that provide substantially discounted tax rates for certain forms of income from intangible property. These regimes have the potential to encourage movement of intellectual property development offshore which, the co-chairs agreed, could have a detrimental impact on the creation and maintenance of intellectual property in the United States. They cited the need for comparable legislative action in the United States in the form of an innovation box regime while noting the need for further work on eligibility criteria.

The co-chairs also agreed that it is important that reform include measures to discourage excessive leverage for both U.S. multinationals and for foreign companies operating in the United States. They expressed concerns about the proportionality proposal in the FY 2016 budget and about potential weaknesses in the TRA 14 proposal, while committing to continued work on appropriate limitations on related-party lending. At the same time, they cited the need to design rules that create a level playing field for inbound and outbound companies.

The FY 2016 budget and TRA 14 would both impose a one-time transition tax on deferred income currently accumulated offshore. The co-chairs agreed in their report to such a transitional framework, while indicating they will continue to study the appropriate discounted rate, the foreign tax credit treatment, and the ratable period.

The report did address one detail of the contemplated framework for international reform. The co-chairs anticipated the new regime may retain the subpart F foreign personal holding company income rules in order to prevent passive investment-type income from qualifying for exemption from U.S. tax. In that event, the co-chairs contemplated retention of the current-law subpart F exceptions under the CFC look-through rule and for active financing income.

Finally, the co-chairs expressed support for the reforms included in the *Real Estate Investment and Jobs Act of 2015* (H.R. 2128), liberalizing the application of the FIRPTA rules. In addition, they cited the need for further study of the deductibility of reinsurance premiums paid to non-taxed foreign affiliates, federal tax policy towards Puerto Rico, and concerns with regard to the Foreign Account Tax Compliance Act (FATCA) and the Report of Foreign Bank and Financial Accounts (FBAR).

Business income tax

The business tax working group (co-chaired by Senators John Thune (R-SD) and Ben Cardin (D-MD)) had arguably the broadest set of issues to evaluate as part of the working group process. Topics within its jurisdiction included (but were not limited to):

- The corporate statutory tax rate
- Business income taxation
- Pass-through business taxation
- Corporate integration
- Cost recovery
- Innovation/R&D
- Interest deductibility
- VAT

In managing this broad scope of issues, the report for the business working group focuses on four principles of tax reform.

The first principle is that the hallmark of successful corporate tax reform is reducing the corporate tax rate. The report cites a KPMG study showing that EU average statutory corporate rate of 22 percent is significantly less than the U.S. rate of 35 percent.

Second, the report concludes that tax reform should address perceived structural biases in the tax code. The report focuses on the role the tax code plays in the choice of entity type (specifically, the growing trend for taxpayers to choose pass-through entities for tax efficiency reasons). Additionally, the report notes that the tax code contains a bias for debt financing over equity financing and also a bias against savings and investment. Among the proposals to consider in addressing these biases, the report mentions corporate integration, special treatment of income earned by pass-through entities, and a consumption tax.

Third, the report notes that tax reform must be done in such a way as to encourage American innovation. This includes revisiting the efficacy of the research credit, considering an innovation box regime, and addressing incentives for energy production. The report acknowledges that creating incentives for innovation, in theory, runs counter to the principle of eliminating biases in the tax code. But in the case of innovation, the co-chairs appeared willing to make an exception.

Finally, the report recommends that tax reform be done in a way that simplifies tax filing, tax reporting, and tax liability calculation. Suggestions include modifying filing deadlines and greater use of electronic filing.

Savings & investment

Although this working group had jurisdiction over a large number of tax issue areas, including capital gains and dividends, financial products, defined benefit and defined contribution plans, the group co-chairs, Senators Mike Crapo (R-ID) and Sherrod Brown (D-OH), focused their energies on the area of private retirement savings. This was the space where it was deemed bipartisan consensus could be most readily achieved. Accordingly, the co-chairs decided not to address the remaining issues.

While the co-chairs agreed not to endorse specific proposals in the report, the report identified three goals for tax writers to focus upon when considering proposals in the area of private retirement savings: (1) increasing access to tax deferred retirement savings; (2) increasing participation and levels of savings; and (3) discouraging leakage while promoting lifetime income.

Toward these three goals, the report identifies a number of areas that deserve further examination and possible legislative attention:

Increasing access to plans

- Increase employer access to open multiple employer plans
- Increase start-up and matching credits for small employers to assist in offsetting start-up and matching contribution costs
- Modify and expand credits and safe-harbors for employers who offer automatic enrollment plans

Increasing participation and contribution levels

- Increase access of part-time workers to retirement savings plans
- Promote savings for middle-income families, such as expansion and modification of the saver's credit, clarifications to church plans and improvements for S-ESOPs

Preserving savings and making them last through retirement

- Exclude portions of lifetime annuity payments from gross income
- Encourage lifetime income streams and increase the portability of lifetime income
- Limit the use of retirement funds for non-retirement purposes, including modification of 401(k) loan repayment requirements

Individual income tax

In the opening paragraph of their report, the individual income tax reform working group co-chairs, Senators Chuck Grassley (R-IA), Mike Enzi (R-WY) and Debbie Stabenow (D- MI), acknowledged that there exists "significant longstanding rifts, and obstacles" to achieving bipartisan agreement for individual tax reform. In deference to these difficulties, the co-chairs agreed to focus their attention upon three topics—charitable giving, higher education and tax administration—as a partial means to achieving the goal of making the tax code fairer and less complex for individual taxpayers.

The co-chairs did not make specific recommendations, but rather attempted to identify policy areas within each of these three topics that they deemed the full Senate Finance Committee should consider examining for possible areas of reform.

Issues of interest mentioned in the working group's report include:

Charitable giving incentives

- Qualified charitable distributions from IRAs
- Qualified conservation contribution rules

Tax incentives for higher education

- Possible consolidations of existing credits and deductions
- Expand proper usage of education incentives by eligible taxpayers
- Pell Grant modifications

Tax administration and simplification proposals

- Combating IRS identity theft

- Tax return due date simplification

Infrastructure

The report for the community development and infrastructure group (co-chaired by Senators Dean Heller (R-NV) and Michael Bennet (D-CO)) focused principally on alternatives for funding the Highway Trust Fund. The Highway Trust Fund, in recent years, has not had sufficient funding to fully finance certain infrastructure commitments. Throughout 2015, Congress has considered several alternatives to meet the funding shortfall.

The working group's report considers Highway Trust Fund financing alternatives on both an interim and a long-term basis. It does not, however, mention increasing the gas tax as an option. Instead, as an interim measure, the report cites the estimated $2 trillion of past foreign earnings of U.S. multinationals as a potential source of revenue for addressing the trust fund shortfall. Specifically, the report suggests that a "deemed repatriation" of these earnings would raise significant revenue toward the $90 billion needed to fund the Highway Trust Fund through 2021.

The report notes that both the Tax Reform Act of 2014 bill introduced by then Ways & Means Chair, Dave Camp, and the administration's FY 2016 budget have made similar proposals to use repatriation revenue to fund infrastructure. It is worth noting, however, that both did so only in the context of comprehensive tax reform.

The report concludes with a consideration of options for long-term funding for transportation infrastructure spending. In particular, a vehicle miles traveled (VMT) tax is recommended as a possible option for consideration, with the possibility of implementing a pilot program. The appeal of the VMT is that it would generally place the cost of maintaining roads with those individuals who use them most. Still, the VMT raises other challenges including potential regressivity and privacy concerns.

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