JOINT COMMITTEE ON TAXATION
April 13, 2016
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TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE HOUSE WAYS AND MEANS TAX POLICY SUBCOMMITTEE HEARING ON FUNDAMENTAL TAX REFORM PROPOSALS[1]

APRIL 13, 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. Beginning 100 years ago, the Congress has relied primarily on the income tax to fund the Federal government. While considering alternatives,[2] in the Tax Reform Act of 1986 the Congress and President Reagan decided to reform the existing Federal income tax generally by broadening the base of income tax and lowering statutory tax rates.

In this subcommittee's hearing on March 22, 2016, Members of Congress presented proposals that would reform the Federal tax system by shifting the tax base from an income tax base to what economists refer to as a consumption tax base. For today's hearing, Chairman Boustany and Ranking Member Neal have asked me to briefly review the legislation introduced by former Ways and Means Committee Chairman Dave Camp in the 113th Congress, H.R. 1, the "Tax Reform Act of 2014."[3] That legislation, like the Tax Reform Act of 1986, proposed broadening the base of income tax while lowering statutory tax rates.

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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 House Ways and Means Tax Policy Subcommittee Hearing on Fundamental Tax Reform Proposals* (JCX-26-16), April 13, 2016. This document can also be found on the Joint Committee on Taxation website at http://www.jct.gov.

[2] Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, 1984, vols. 1-3.

[3] 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.

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?
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 individuals 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 economize on compliance costs by 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. Among the goals former Chairman Camp set as additional constraints were 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 pass through business income. There are always tradeoffs. Former Chairman Camp's introduced legislation is the result of such tradeoffs.

<u>Taxation of Individual Income</u>

H.R. 1 reduces the top effective marginal tax rate on individual income to 35 percent, broadens the tax base by repealing a number of itemized deductions and credits, and simplifies tax filing by increasing the standard deduction.

<u>Rate reduction</u>

- Reduces effective marginal tax rates on individual income to 10, 25, and 35 percent.
    a. 40 percent deduction for individuals' dividends and capital gains (creating effective marginal tax rates of 6, 15, and 21 percent).

<u>Base broadening</u>

- Repeals deduction for all State and local taxes.
- Modifications of other deductions (*e.g.*, charitable deduction, mortgage interest deduction, moving expense deduction).
- Repeals dependent care credit.

- Repeals non-business energy property credit, credits for energy-efficient property, and credits for alternative fuel vehicles.
- Repeals or modifies certain other exclusions (*e.g.*, exclusions for employee fringe benefits).

Simplification

- Increases the standard deduction and repeals deduction for personal exemptions.
- Repeals the individual alternative minimum tax ("AMT").
- Consolidates tax incentives for education.
    a. Repeals seven different tax incentives for education.
    b. Modifies and makes permanent the American Opportunity Tax Credit.

Reducing income tax rates and broadening the tax base may promote growth by increasing labor supply and eliminating distortions that create non-neutralities in the marketplace. However, these measures also have distributional consequences, and H.R. 1 maintains distributional neutrality by increasing the child tax credit, modifying the earned income tax credit, and increasing the standard deduction (among other measures).

Taxation of Business Income

H.R. 1 promotes investment by reducing the corporate income tax rate to 25 percent, but at the same time increases the cost of capital through several base-broadening measures.

Rate reduction

- Reduces corporate income tax rate to 25 percent.
- Repeals corporate AMT.
- Modifies and makes permanent the research credit.
    a. Repeals the traditional 20 percent research credit and energy research credit.
    b. Makes permanent the alternative simplified method (increases rate to 15 percent) and basic research credit (reduces rate to 15 percent and changes the base period from a fixed period to a three-year rolling average).
    c. Eliminates the research credit for computer software, removes supplies from definition of qualified research expenses, and eliminates ability to claim a reduced research credit in lieu of reducing research and development costs otherwise allowed.

Base broadening

- Changes depreciation rules.
    a. Expands expensing permitted under section 179.

b. Allows bonus depreciation to expire.

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

d. Makes available election to index basis to chained consumer price index for all urban consumers ("CPI-U").

- Requires amortization of 50 percent of advertising expenditures over 10 years.
- Requires amortization of research and experimentation expenditures over five years.
- Repeals last-in, first-out ("LIFO") and lower of cost or market ("LCM") methods of accounting.
- Phases out section 199 domestic production activities deduction.
- Repeals 23 energy-related tax incentives.
- Repeals other business credits (*e.g.*, FICA tip credit, rehabilitation credit, Work Opportunity Tax Credit ("WOTC"), railroad track maintenance credit).
- Limits net operating loss ("NOL") deduction to 90 percent of taxable income.
- Repeals private activity bonds.

Simplification

- Repeals corporate AMT.

While the base-broadening measures of H.R. 1 increase the cost of capital, they can lead to a more efficient pattern of investment by eliminating non-neutralities created by tax incentives that benefit specific types of investment.

Taxation of Cross-Border Income

H.R. 1 establishes a 95 percent participation exemption system that reduces residual U.S. income tax liability on foreign-source income earned through controlled foreign corporations, effectively lowering the rate of tax applicable for repatriated foreign-source income to 1.25 percent. However, the bill also establishes a new category of subpart F income—foreign base company intangible income—that, while taxed at a reduced rate of 15 percent, broadens the income base that is subject to current taxation by the United States.

Joint Committee on Taxation Staff Analysis of H.R. 1 (FY 2014-2023)

Revenue estimate

- H.R. 1 is roughly revenue neutral, raising $3 billion over the budget period.

- For reference, the Congressional Budget Office projects individual income tax receipts of $21.7 trillion and corporate income tax receipts of $4.0 trillion over FY 2017-2026 under present law.[4]

Distributional analysis

- Average tax rates under present law and H.R. 1 are estimated to be similar across the income distribution over the budget period.
  a. JCT staff analysis distributes the corporate tax burden.

Macroeconomic analysis

- H.R. 1 is estimated to result in the following changes in aggregate economic activity (depending on the macroeconomic model used):
  a. Increase in real gross domestic product ("GDP") by between 0.1 percent and 1.6 percent by the end of the budget period.
  b. Change in private business investment between -0.6 percent and 0.1 percent.
  c. Increase in labor force participation between 0.3 percent and 1.5 percent.
  d. Increase in private sector employment between 0.4 percent and 1.5 percent.
  e. Increase in household consumption between 0.4 percent and 2.1 percent.

[4] Congressional Budget Office, *Updated Budget Projections: 2016-2026*, March 2016, p. 2.