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FROM: Casie Daugherty, Prime Policy Group

SUBJECT: Senate Finance Committee Hearing on Tax Reform

Today, the Senate Finance Committee held a hearing entitled "Business Tax Reform."

The hearing covered issues including interest deductibility, corporate integration, expensing, the impact that lower corporate tax rates would have on American workers, and a cash accounting system. Additionally, a substantial amount of the hearing was devoted to passthrough entities.

Committee Members' Opening Statements
Committee Chairman Orrin Hatch (R-UT)
At the start of the hearing, Chairman Hatch once again said that the bill that the Senate Finance Committee will consider will go through regular order. This, he stated, would include the drafting of such a bill.

Ranking Member Ron Wyden (D-OR)

Witnesses' Opening Statements
Scott Hodge, President of the Tax Foundation

Dr. Donald B. Marron, Institute Fellow at the Urban Institute and Urban-Brookings Tax Policy Center

Troy K. Lewis, Immediate Past Chair of the Tax Executive Committee at the American Institute of Certified Public Accountants

Jeffrey D. DeBoer, President and CEO of The Real Estate Roundtable

Q&A Round 1:

Chairman Hatch: You note that the Tax Foundation is generally supportive of corporate integration. The Tax Foundation estimated almost 3% economic growth and 535,000 new full time jobs from corporate integration. Please share the Tax Foundation's views on corporate integration and the dividends paid approach in particular.

> **Mr. Hodge:** Since 1977, there have been more than a dozen proposals on corporate integration from Congress or the White House. Unfortunately, nothing has come from them. We believe that business income should be taxed only once. It has a substantial impact on long-term economic growth and equalizes debt and equity financing. A dividends-paid deduction is a thoughtful way to approach this.

Chairman Hatch: You include concerns on the limits of the deductibility of interest expenses in your written statements. However, we frequently hear about how the current tax treatment of debt and equity financing leads to overleveraging of businesses. I would like your thoughts on that.

Mr. Lewis: Equity financing is simply not available for many start-ups and small or medium sized businesses. Taking away interest deductions will put more pressure on small businesses. Tax laws shouldn't discriminate on businesses.

Mr. DeBoer: The issue of overleveraging should be examined on an individual basis. If there is overleveraging, it is a problem with the regulators. All businesses need this flexibility to use debt. We see no reason to address it in the tax code.

Chairman Hatch: Two of the witnesses have ideas on how compensation or wage income are taxed at the new passthrough rate.

Mr. Lewis: Our laws should encourage the creation of passthrough entities. A passthrough entity has the same type of demands that a C-Corp as. There should be consistent treatment in the tax code for all. We propose an anti-abuse type of regime, which codifies the standard that is administered currently through the court. You want to create a rule within the law, as well as an easily administered provision for the IRS

Mr. DeBoer: Our proposal is a little complicated, but we are reaching out to staff to get opinions on it. We pledge to work with the committee to make sure that true compensation to an entity does not get taxed at a lower rate, and there is no gamesmanship. These entities do have income like rents for a real estate company and that income should get taxed at a lower rate.

Sen. Chuck Grassley (R-IA): As part of a pro-growth tax reform, there is debate over lower rates or expensing. Can you elaborate on how you see the trade off? Do you view lengthened depreciation as acceptable to finance lower rates?

Mr. Hodge: We see expensing as the most powerful policy change that you can make to improve economic growth. Full expensing delivers twice the benefit as a comparable rate cut. That's because it effects new investment. We need to look back at Chairman Camp's proposal for the second question, which lengthened depreciation to finance a corporate rate cut. All the models found that lengthening depreciation raise the cost of capital to such an extent that it offset the benefits of a corporate tax rate cut.

Dr. Marron: If you focus on expensing, you are providing incentive for new investment, which is most beneficial for the economy and the worker. That said, with a 35% rate, you can make an argument to bring the rate down for competitive reasons.

Sen. Grassley: Should any restriction on the deductibility of interest be considered to finance lower rates or faster depreciation?

Dr. Marron: There are two schools on how you should tax: the income tax school and the consumption tax school. In the income tax school, you ought to be able to deduct it. In the consumption school, you should be able to expense everything immediately. We have a combination system. I am open to reducing interest deductibility if it is paired with making depreciation more favorable.

Mr. DeBoer: I would echo much of what he said. Some industries are perhaps over reliant on it, and it would be disruptive.

Sen. Tom Carper (D-DE): Can you discuss what impact deficit-financed tax cut would have on long-term economic growth for the U.S. economy and on our deficits?

Dr. Marron: Our current deficit trajectory is problematic. Deficit-financed tax cuts would lead to more of that. The financing of that would have to come from somewhere, like pulling from investment in the U.S.

Sen. Carper: Can you discuss what the evidence shows on who really bears the cost for corporate tax and your view that a rate cut would allegedly help workers.

Dr. Marron: This is an area that economists have studied recently. Clearly workers pay some of the corporate tax rate. Mainstream estimates are around 20%. My colleagues emphasize that it differs, in some systems it goes up to 50%.

Sen. Pat Toomey (R-PA): Is there anyone on the panel that believes that economic growth and output is completely unaffected by all incentives and penalties in the tax code? [None or the panelists replied in the affirmative.] Isn't there an unavoidable logic that if you get the incentives right, you will have more growth, generating more revenue?

Mr. Hodge: That's correct. We try to tell people on dynamic scoring that most tax cuts don't pay for themselves but depending on the type of tax cut, it will have macroeconomic effects.

Sen. Toomey: You seem skeptical about the wisdom for allowing full expensing for structures but not other kinds of assets. You think the expensing for those other assets can be beneficial, correct?

Mr. DeBoer: I don't necessarily disagree, but under the current law 60% of business investments are recovered within 18 months.

Sen. Toomey: I want to look at the accrual method versus the cash method of accounting. Isn't it true that a fast-growing company that is investing significantly in capital could be in a position that their cash flow is exceeded by their tax liability under an accrual system?

Mr. Lewis: Certainly

Sen. Toomey: Allowing companies to take the cash method has the virtue of simplicity, but also allies their cash flow with their tax liability, correct?

Mr. Lewis: Cash accounting will be simpler and provides a lot of incentive.

Sen. Toomey: Would you be supportive of raising the threshold that is currently in law that would allow for a cash-basis accounting.

Mr. Lewis: The AICPA has supported Sen. Thune's Invest Act, which increases it to make it more available to small businesses.

Sen. Toomey: Could you explain how dollar-for-dollar expensing helps workers.

Mr. Hodge: By lowering the cost of capital, you are improving the opportunity for business to invest in tools, making workers more productive. More productive workers in turn earn higher wages.

Sen. Maria Cantwell (D-WA): Can you comment on housing, as it relates to the tax code, and what we need to do.

Mr. DeBoer: Most businesspeople, especially those who operate in urban areas, recognize the lack of workforce housing. People are being priced out of our nation's cities. We need to find a way to incentivize housing, not just low-income housing, but overall affordable housing.

Sen. Cantwell: Does just cutting the corporate tax rate give us affordable housing?

Mr. DeBoer: No, I don't think it will have any impact on affordable housing. A tax cut might lead to more jobs or higher wages, but it won't directly impact affordable housing.

Sen. Cantwell: Do you think affordable housing is a crisis?

Mr. DeBoer: I'm not sure I would call it a crisis. Construction and land cost virtually the same, no matter what you are constructing, but companies don't see their own economic benefit in constructing affordable housing as opposed to something else.

Sen. Tim Scott (R-SC): Can you speak on compliance costs under the current code and what it means long-term?

> **Mr. Hodge:** Americans spend 9 billion hours complying with the tax system. The corporate part is the most expensive. This is money and time that is drained from businesses. This is wasted time, energy, and resources.
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> **Mr. Lewis:** The AICPA has 12 guiding principles for tax reform, including equity/fairness and simplicity. The problem is that one principle often has to be sacrificed for another. The code will probably never be simple, but you can make it less complex.

Sen. Pat Roberts (R-KS): What do you think about the 1986 act?

> **Mr. Hodge:** We modeled the 1986 act, and it actually raised the cost of capital on businesses at the expense of giving cuts to individuals.

Sen. Ben Cardin (D-MD): What is a fair way of handling passthrough entities? They don't have double taxation, but when you look at global competition, they are still paying a much higher rate than global competitors. How do we protect these passthroughs?

> **Mr. DeBoer:** Very few real estate companies are operated in corporate format. Almost all are LLCs or other passthroughs. We are very focused on achieving a lower tax rate for those entities. Right now, there is a 5% spread between the corporate rate and the individual rate. We see no reason that a similar spread shouldn't be adopted in reform.

Sen. Cardin: I think competitive rates are impossible without another type of tax. We are the only developed country without a consumption tax. How do you get to competitive global rates using only income revenue?

> **Dr. Marron:** You are left with a lot of bad choices. I end up in the same places you are. The destination-based tax was a way, and there are other consumption taxes. I personally like the carbon tax. You can also look to shareholders.
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> **Mr. Hodge:** I applaud your progressive system that was extremely pro-growth.

Sen. Sherrod Brown (D-OH): What are some ways we safeguard against corporate tax reform that overwhelmingly helps corporate America at the expense of American workers?

> **Dr. Marron:** You want to deemphasize the cuts that are geared toward shareholders. You also want to look beyond the business tax code to things like the EITC

Sen. Dean Heller (R-NV): Evidence suggests that workers bear 45% of the corporate tax burden. Is that accurate?

> **Mr. Hodge:** Yes. We have a paper coming out next week, that shows a substantial portion falls on workers. Corporate taxation can have an overwhelming influence on hiring and wages.

Sen. Heller: I have your literature that suggests a 20% tax rate lifts wages an average of 3.5%. Do you stand behind that?

> **Mr. Hodge:** Yes, our model shows that. Growth and productivity growth increases wages.

Sen. Heller: Your literature also suggests that the combination of a 20% tax rate and full expensing shows a boost in after-tax income an average of 5.2%. Do you stand behind that?

> **Mr. Hodge:** Yes, absolutely.

Sen. Heller: Can you elaborate on any on this? We are trying to get to individual tax relief.

Mr. Hodge: Tax relief for individuals is important, but if you haven't had a raise in more than a decade, a tax cut doesn't really benefit you. We want a tax policy that lifts wages and productivity.

Sen. John Thune (R-SD): Can you elaborate on the connection between business tax relief and tax relief for middle class workers and families?

Mr. Hodge: When the OECD studied which taxes were most harmful for growth, they found that the corporate income tax is the most harmful because capital is the most mobile factor in the economy. The primary goal should be to lift people's real standard of living.

Sen. John Thune (R-SD): You make the case against the immediate expending of real estate given the unique nature of these assets. Would shortening the recovery period from commercial buildings from 39 years and from rental housing from 27½ years be a solution?

Mr. DeBoer: Yes, we strongly believe that. We are interested in the life of real estate. MIT's study says that real estate's lifespan is closer to 20 years than 39.

Sen. Thune: You suggest a 20-year recovery period. Would you apply that to both residential and nonresidential?

Mr. DeBoer: I would, but there might be an argument for a different lifespan.

Sen. Thune: Should we consider expanding the 15-year lifespan for improvements to certain types of real property or shorten that as well?

Mr. DeBoer: If tax reform adopts an expensing provision for assets except for those with longer lives (like structures), I would say that leasehold improvements should be expensed like any other business expense.

Ranking Member Wyden: There has been a proposal to create a special passthrough income rate, which strikes me as a tax giveaway for the top 1% in the guise of being a help for small businesses. In your view, how much of the benefit will got to the top 1%?

Dr. Marron: If you do a maximum rate, the definition mostly goes to people at the top tax bracket.

Ranking Member Wyden: What do you think of the Trump Administration's statement that there are ways to prevent unscrupulous individuals from turning this tax rate into a massive loophole?

Dr. Marron: It is a race. You are going to create a lot of people along the "scrupulousness" dimension. If there are benefits, people are going to take advantage of the incentive. The IRS will write some rules to solve this, but people will definitely take advantage.

Ranking Member Wyden: There are some that want to bring back temporary, debt-financed tax cuts. We have seen this movie before (the Bush tax cuts). You get a small bump in the short term, followed by lagging growth. What happens when you do a temporary tax cut?

Mr. Hodge: Temporary tax cuts can be sort of a "Cash for Clunkers." It draws activity into the present and future activity declines. Long-term economic activity declines below the baseline due to drawing returns immediately.

Sen. Mark Warner (D-VA): Most of our global competitors make up for their lower rates by having a VAT or a GST. In the *Wall Street Journal* today, the Republicans are advocating a $1.5 trillion tax cut. In a country that already has $20 trillion in debt and based on some of the growth rates, what effect will that have on the economy.

Dr. Marron: If you look at CBO's estimates, we are on track to add about $10 trillion to the debt. Adding another $1 trillion, that would make it even more of a challenge. The economy continues to lag. If you expand the deficit now, you have the traditional problem that the resources have to come from somewhere.

Sen. Warner: Recently, we have also had the good fortune to have relatively low interest rates. I'm concerned if they go up, we will be able to pay for an army and debt payments and not much else.

Dr. Marron: If, as CBO anticipates, there is a dramatic increase over time.

Sen. Claire McCaskill (D-MO): More than half of passthrough income in the U.S. goes to the top 1% of all taxpayers. So, the data would suggest a simple rate cut greatly impacts the top 1%. Could you speak to how this passthrough tax cut would create incentive for gaming the system

Dr. Marron: If we go down the path of creating a new passthrough rate, just by construction it will go to high-income people. Mechanically it will have that effect, and it creates a loophole effect. There are a lot of good things about passthroughs, but you don't want the tax code to over-reward them.

Sen. McCaskill: Can you explain how things went so awry in Kansas?

Dr. Marron: The situation in Kansas was extreme. Ordinary people in Kansas reorganized their income solely to qualify for that benefit without creating any new economic benefit. It was a completely nonsensical approach.

Sen. McCaskill: Let's talk about complexity for a minute. How much more economic activity would we have if we could decide on how to define a "child" or a "small business" in the tax code?

Mr. Lewis: The tax code will probably never be simple, but it sure be less complex. Well-meaning legislators over time put things in the code without taking anything out.

Sen. McCaskill: Do you think it is realistic that Congress can do this process well in 60 days? Can we actually provide permanency, stability, less complexity, predictability?

Mr. Lewis: The effort for tax reform has been happening for a long time. There has been a lot of work that has gone into this effort.

Sen. Debbie Stabenow (D-MI): It is important that we are looking at subsidies that don't make sense any more, including those provided to the top five biggest oil companies. They may have made sense 100 years ago, but they make absolutely no sense today. Does the evidence show that these oil company subsidies provide benefits to consumers that warrant keeping them?

Dr. Marron: I haven't seen evidence to suggest that.

Sen. Stabenow: What should we be doing to target tax dollars to create American jobs?

Dr. Marron: On the business side, it is to encourage investment in the U.S., especially the kind of investment that has the most benefit. R&D has spillover benefits to the rest of the economy.

Sen. Stabenow: When we talk about cutting interest deductibility, we're actually talking about raising taxes on small businesses who are creating jobs.

Dr. Marron: One of the challenges is that some portions of the economy, like small businesses, already have full expensing for their investment. So, a tax reform proposal that moves to expensing and limits interest deductibility doesn't benefit them.