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Finance Committee tax reform working groups show their work

After six months of work and two deadline extensions, the five bipartisan Senate Finance Committee working groups tasked with reviewing and making recommendations on overhauling discrete areas of the tax code released their final reports on July 8. (The text of the reports is available on the Finance Committee Web site.)
URL: http://www.finance.senate.gov/newsroom/chairman/release/?id=E9EEFC66-7E11-4276-939F-3ECA6FD6D959

This edition of *Tax News & Views* provides some observations about the working group process, a high-level overview of what's in the reports, and a discussion of how their release could that could spur efforts to pair international tax reforms with a must-pass bill on highway spending.

A few observations about the process

When Finance Committee Chairman Orrin Hatch, R-Utah, and ranking Democrat Ron Wyden of Oregon convened the working groups back in January, they set into motion a process that was viewed by many at the time as a potential boost to tax reform prospects. Hatch and Wyden explained that the each group would "analyze current law and examine policy trade-offs and available reform options within [its] designated topic area" and "work directly with the nonpartisan Joint Committee on Taxation…to produce an in-depth analysis of potential legislative solutions"; moreover, the two Finance Committee leaders envisioned that the collective recommendations of the working groups "would serve as a foundation for the development of bipartisan tax reform legislation." (For prior coverage, see *Tax News & Views*, Vol. 16, No 2, Jan.16, 2015.)
URL: http://newsletters.usdbriefs.com/2015/Tax/TNV/150116_1.html

But as the process wore on, expectations that the reports would be a catalyst for action on comprehensive tax reform in 2015 were tempered. There was talk on Capitol Hill that some of

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the groups were having difficulty reaching consensus on substantive recommendations. (For prior coverage, see *Tax News & Views*, Vol. 16, No. 18, May 22, 2015.) And that challenge was made even harder as the working group process was carried out amid a growing realization that comprehensive tax reform is very unlikely this year in the face of clear partisan differences on whether tax reform should be revenue neutral or raise additional revenues and whether the tax code should be more progressive by increasing the share of the tax burden borne by upper income taxpayers.
URL: http://newsletters.usdbriefs.com/2015/Tax/TNV/150522_3.html

One outcome of this process is that it serves as another reminder that fundamental tax reform involves difficult choices for lawmakers and many of them will be hesitant to commit to details too early in the process, especially if they don't have a clear picture of all of the moving pieces.

International tax reform (Co-chairs Rob Portman, R-Ohio, and Charles Schumer, D-N.Y.)

Of the five working groups, the international tax panel's report has perhaps garnered the most attention due to the potential for international tax reform to provide a mechanism to fund highway reauthorization and also because there have been indications that the two co-chairs – Rob Portman and Charles Schumer – were working closely together to arrive at bipartisan recommendations. Although the report is 81 pages, the bulk of it is devoted to a discussion of the current US international tax rules and the issues facing lawmakers in reforming the code. The recommendations can be found in the last 10 pages – a section referred to as the "Bipartisan Framework" – and it is not clear how many of those recommendations have the support of panel members other than co-chairs Portman and Schumer.

For the most part, the recommendations draw heavily from both the international provisions of the tax reform plan that then-House Ways and Means Chairman Dave Camp, R-Mich., released in 2014 and the international tax reform component of President Obama's fiscal 2016 budget proposal. (For coverage of Camp's plan, see *Tax News & Views*, Vol. 15, No. 9, Feb. 27, 2014; for coverage of the president's budget, see *Tax News & Views*, Vol. 16, No. 6, Feb. 6, 2015.)
URL: http://newsletters.usdbriefs.com/2014/Tax/TNV/140227_1.html
URL: http://newsletters.usdbriefs.com/2015/Tax/TNV/150206_1.html

Territorial system and base erosion: Citing the adoption of territorial systems by most OECD and G-7 members as well as the so-called lockout effect of the current system (which critics say encourages companies to leave their earnings offshore rather than repatriate them back to the US), Portman and Schumer recommend the adoption of a dividend exemption system. They do not specify whether the dividend exemption should be 100 percent or some lower percentage (such as the 95 percent exemption proposed in the Camp plan). Notably, their report calls for pairing that with a reduction of the US corporate statutory rate but does not specify what the corporate tax rate should be under a reformed tax code.

Portman and Schumer observe that they see the need for "robust and appropriate base erosion rules," but they do not elaborate, other than to say that they are continuing to look at options. If a minimum tax on foreign earnings (such as the one included in the Obama proposal) is adopted, they say that the rate and the type of income it applies to should prevent base erosion while ensuring the competitiveness of US multinationals.

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The report notes that the treatment of branches and S corporations under a territorial system present unique challenges, but it does not make recommendations in these areas.

Repatriation: Portman and Schumer say they agree with the deemed repatriation frameworks put forth by Camp and Obama, but those frameworks differ significantly on rate and the application to different types of assets. The co-chairs do not endorse any of the details of those plans and say they continue to work on the issues related to rate (including whether to impose different rates for cash and noncash assets), as well as tax credits and ratable payments.

Innovation box: The report discusses the OECD's Base Erosion and Profit Shifting (BEPS) Project, which the United States is a party to, and expresses the concern that actions taken by other countries under the project will harm US multinationals and the domestic economy. The report also cites the BEPS Project's scrutiny of other nations' innovation and patent box regimes – which generally provide a special tax rate for the exploitation of intellectual property that is developed domestically – and notes that the introduction of nexus requirements for those regimes "will have a significant detrimental impact on the creation and maintenance of intellectual property in the United States, as well as on the associated domestic manufacturing sector, jobs, and revenue base."

In light of these developments, Portman and Schumer recommend that the United States adopt an innovation box, although they do not provide specific details on how a US innovation box would operate. However, they say they continue to work on the details of eligibility criteria, nexus, and domestication of offshore intellectual property.

Interest expenses: The report makes no concrete recommendations with respect to interest expense limitations as have been suggested by Camp and the administration. Portman and Schumer say they continue to review proposals to "determine the appropriate net limitation necessary" for legitimate intra-group lending while preventing inappropriate leveraging to avoid US taxation. They also state that they are committed to offering rules that will keep inbound and outbound companies on a level playing field, and note that they will look at whether additional interest rules should be implemented on companies that invert.

Subpart F exceptions: The report notes that the current rules on foreign personal holding company income might still be needed in a reformed system to prevent certain types of passive income from qualifying for exemption from US tax. If those rules are retained, Portman and Schumer say the controlled foreign corporation lookthrough and the active financing exceptions to subpart F would need to be retained as well.

FIRPTA: To encourage foreign investment in the United States, Portman and Schumer recommend reforms to the Foreign Investment in Real Property Tax Act. Specifically, they support the Real Estate Investment and Jobs Act (H.R. 2128), which was introduced in April by Ways and Means Committee member Kevin Brady, R-Texas. That bill would increase the ownership stake a foreign investor can take in a US real estate investment trust and exempt foreign pension funds from FIRPTA.

Other issues: The report notes that the co-chairs are also looking at the issues of foreign affiliate reinsurance, taxation in Puerto Rico and other US possessions, and the taxation of US citizens living abroad – primarily with respect to issues with FBAR and Foreign Account Tax

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Compliance Act (FATCA) reporting. It makes no specific recommendations in these areas, however.

Community development and infrastructure (Co-chairs: Dean Heller, R-Nev., and Michael Bennet, D-Colo.)

This report was submitted on behalf of the co-chairs and not the entire working group. It notes that the co-chairs and other individual members of the working group may release bipartisan legislative proposals in the near term.

Heller and Bennet offer what they dub an “interim option” to finance highway spending – which would fund a six-year infrastructure bill – as well as a long-term option. The interim option calls for imposing a deemed repatriation tax on the more than $2 trillion of deferred foreign-source earnings of US multinationals; however, the report does not recommend a specific rate or a timeline for paying the tax, other than to note that it could be done “over several years.” In a footnote, the co-chairs observe that “[c]ertain working group members would have concerns with deemed repatriation legislation unless it was considered in conjunction with fundamental tax reform which broadened the base and lowered tax rates.”

As a long-term option, the co-chairs propose consideration of a nationwide vehicle miles traveled (VMT) tax, which would first be implemented as a pilot program to ensure its feasibility. The report says a VMT tax “has the potential to improve the efficiency of highway financing because the tax can be calibrated closely to the costs that vehicles impose in terms of road damage and congestion…[and] could be calculated based on time of day, congestion, type of road, type of vehicle, etc.” The co-chairs note that it could take as long as a decade to fully implement such a program nationwide.

Business income tax (Co-chairs: John Thune, R-S.D., and Ben Cardin, D-Md.)

This report, which was submitted on behalf of the entire working group, highlights two “threshold issues” that the working group argues are key to the success of any reform plan: lowering the corporate tax rate and treating passthrough businesses equitably.

The report includes a lengthy discussion of the challenges inherent in lowering the corporate tax rate in a revenue neutral way and details the options and trade-offs for base broadening.

Passthroughs: Noting that the consideration of passthrough entities bleeds into the individual side of the tax code – which was not the jurisdiction of this panel – the report discusses several options to address equitable treatment of businesses if legislation is considered to lower the corporate tax rate but not individual marginal rates. These options include:

- Business equivalency, which would tax all active business income, regardless of business form, at the same rate;
- Enhanced tax benefits for passthroughs to offset an unchanged statutory rate; and
- A new flowthrough deduction that would apply only to active business income of passthrough entities.

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According to the report, each of these options has challenges, and details would need to be further developed. The working group could not reach consensus on a single option to recommend.

Double taxation: In considering the issue of double taxation of business income, the working group presents a discussion of "partial corporate integration," in which undistributed income would be taxed at the corporate level and income distributed to shareholders would be taxed only once. Noting the numerous challenges in each of the options the working group considered, the report does not endorse any specific corporate integration proposal. It does, however, refer to the *Finance Committee Staff Report on Comprehensive Tax Reform for 2015 and Beyond* (released in December of 2014) and urges committee leadership to further explore corporate integration. (For prior coverage, see *Tax News & Views*, Vol. 15, No. 39, Dec. 12, 2014.)
URL: http://www.finance.senate.gov/newsroom/ranking/download/?id=7798ca64-6955-4c9e-b6f9-9f7954b4e08e
URL: http://newsletters.usdbriefs.com/2014/Tax/TNV/141212_3.html

Income v. consumption tax: The report also considers the current bias against savings that is inherent in an income tax system and outlines the benefits that might result from a shift towards a consumption-based tax system. The working group notes that such a shift would be a major change that could not be done in the short term but encourages Senate taxwriters to give the concept their attention.

R&D incentives: Focusing on policies that would promote innovation, the report appears to endorse a strengthened and permanent incentive for research and development, and includes a discussion of adding an "innovation box" regime to the tax code (paired with international reform).

Energy: While noting that the members of the working group differ on whether the federal government should continue to favor certain types of energy sources or production over others or create a neutral tax system for all types of energy, the report discusses two points of consensus, namely, that energy tax policies should be:

- Stable and predictable and
- Aimed at "providing targeted and efficient incentives to overcome market failures" and then "phased out in a fair and predictable way as the goals of those incentives are reached or as industries and technologies mature."

Ideas mentioned as worth further consideration include extending Master Limited Partnership treatment to renewable energy projects and source-neutral policies that encourage energy efficiency and efficient storage and transmission.

Tax simplification: Finally, the working group encouraged consideration of simplification ideas including rationalizing filing deadlines, electronic filing of Form 990s, expanded declaratory relief for 501(c) entities, simplification of the private foundation excise tax, an enhanced deduction for food inventory donations, and permanent disaster relief provisions.

Individual income tax (Co-chairs: Charles Grassley, R-Iowa, Mike Enzi, R-Wyo., and Sen. Debbie Stabenow, D-Mich.)

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Given the range of issues the working group's jurisdiction, this report is fairly narrow in its scope. The co-chairs explain in a foreword that "there are many differing views on what constitutes a 'fair' tax system, what level of revenue our tax system should raise, how tax rates affect growth, the degree of progressivity tax reform should aim for, and many other broad structural changes that could be made to the code." The foreword also alludes to challenges the working group faced in balancing its jurisdiction with that of the working group on Business Income Taxes, particularly with respect to rules and tax rates applicable to passthrough entities. As a result, the working group's report focuses on only three areas of individual income tax policy – charitable giving, higher education, and tax administration – and notes they are the only ones that appeared to provide room for potential bipartisan agreement. Even so, the report goes on to caution that not all working group members agree with any or all of the specific proposals identified in those areas.

Charitable giving: Reform options the report recommends for consideration in this area include:

- Permanently extending the exclusion from gross income for qualified charitable distributions from an IRA and expanding the types of charities to which qualifying distributions can be made (e.g., to donor-advised funds, private foundations, etc.) and/or increasing the annual dollar limit for such distributions (currently $100,000); and
- Permanently extending the increased charitable percentage limits and extended carryforward period for qualified conservation contributions, and ensuring that conservation easements are properly valued and serve a legitimate conservation purpose.

Higher education: Recommendations here include:

- Repealing the Lifetime Learning Credit in favor of a permanent and expanded American Opportunity Tax Credit (AOTC), or alternatively, combining the AOTC, Hope credit, Lifetime Learning Credit, and tuition and fees deduction into a single credit for all post-secondary education; and
- Excluding all Pell Grant amounts from taxable income, without regard to the use of the proceeds (e.g., tuition and fees versus room and board).

Tax administration: The report recommends that Congress consider ways to:

- Prevent tax-related identity theft through measures such as extending the IRS's authority to use truncated Social Security Numbers on Form W-2, adding civil and criminal penalties targeted at identity theft, notifying taxpayers of suspected identity theft, providing a single point of contact for identity theft victims, and studying an expansion of the Identity Protection Personal Identification Number (IP PIN) system;
- Streamline and rationalize tax return due dates by, for example, requiring passthrough entities to file in advance of their individual and corporate investors;
- Conform the filing due date for FBAR reporting with income tax filing due dates; and
- Accelerate the filing deadline for information returns related to employee remuneration.

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Savings and investment (Co-chairs: Mike Crapo, R-Idaho, and Sherrod Brown, D-Ohio)

This report was drafted by the group's co-chairs and submitted on behalf of the entire working group. Although defined benefit pension plans and the tax treatment of capital gains and dividends were within the group's jurisdiction for review and recommendation, the report focuses solely on tax policy issues surrounding private retirement savings. The report notes that bipartisan consensus did not exist in other areas of the group's policy portfolio.

With respect to private retirement savings, the working group identified three key areas it believes lawmakers should focus on: (1) increasing access to tax-deferred retirement savings plans, (2) increasing plan participation and savings rates among participants, and (3) promoting lifetime income streams and discouraging asset leakage during working years.

Increasing access: The report notes that tax reform can make tax-deferred retirement savings plans more accessible to individuals by:

- Expanding the ability of small employers to join open Multiple Employer Plans – for example, by loosening rules that require participating employers to share some employment-based nexus or organizational relationship unrelated to the provision of benefits; and
- Increasing the tax credit for retirement plan start-up costs incurred by small employers.

Increasing participation and contribution levels: Potential actions Congress can take in this area, according to the report, include:

- Expanding the ability of part-time workers to participate in employer-sponsored retirement plans;
- Expanding the so-called "Saver's Credit" applicable to qualified retirement savings contributions made by low- and middle-income individuals and families; and
- Encouraging formation of additional S Corporation Employee Stock Ownership Plans (S-ESOPs), such as through enactment of the Promotion and Expansion of Private Employee Ownership Act of 2015 (S. 1212), which, in part, would extend the gain-deferral provisions of tax code section 1042 to sales of employer stock to S-ESOPs.

Preserving savings and making them last through retirement: Recommended reforms in this area include:

- Allowing a partial exclusion of otherwise taxable lifetime annuity payments;
- Allowing plan-to-plan transfers of lifetime income investments should the investment become unauthorized under an employee's current plan;
- Encouraging investment in lifetime income products (e.g., annuities), including consideration of auto-enrollment in such investments upon retirement (with an opt-out); and
- Preventing leakage by extending the payback period on plan loans in the event of job loss and allowing plan participants to continue making elective contributions in the period immediately following a hardship withdrawal.

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Implications for near-term action on highways

Congressional Republican leaders have effectively ruled out the possibility of moving comprehensive tax reform before 2017, citing the Obama administration's refusal to consider reducing marginal tax rates for high-income individuals. The notion of moving business-only tax reform in 2015, which was discussed earlier this year, has also been shelved for now given the small-business community's reluctance to support a business-focused plan that cuts the corporate tax rate without also offering relief to passthroughs by lowering marginal tax rates for individual filers. One plan that has gained momentum in recent weeks, however, involves pairing reform of the international tax rules – including a deemed repatriation tax on foreign-source earnings of US multinationals – with legislation to provide a temporary revenue source for the rapidly dwindling Highway Trust Fund.

The next four weeks are critical in determining whether Congress might pass an international-tax-for-highways package later this year. The House and Senate just started a short sprint toward the August recess and the one "must-do" tax item during this work period is to extend the Highway Trust Fund's spending authorization before it expires on July 31. Knowing that it would be impossible to craft an international tax/highway package in less than a month, House Ways and Means Committee Chairman Paul Ryan, R-Wis., wants to enact a short-term patch, just through the end of 2015, which would give him and his fellow taxwriters time to try to develop a longer-term highway bill paired with international-only tax reform that includes deemed repatriation.

Ryan reiterated his support for deemed repatriation to fund highway spending and his intention to move a short-term Highway Trust Fund patch during remarks at a July 9 breakfast briefing hosted by *Politico*. A day earlier, Ryan also expressed support for the recommendations by the Finance Committee's International Tax working group, noting in news release that he was "pleased that their plan recognizes that a one-time tax on the repatriation of earnings stuck abroad makes sense only in the context of the kind of broader structural changes that they have proposed."
URL: http://waysandmeans.house.gov/ryan-welcomes-portman-schumer-framework-for-new-international-taxation-system/

But others in Congress may be less supportive of another short-term patch and will instead push for a long-term plan by the end of July. Among those likely to seek a longer-term agreement are some of the members of the committees that have primary jurisdiction over highway programs, especially in the Senate, who are eager to provide certainty to road construction and maintenance planners. Senate Majority Leader Mitch McConnell, R-Ky., is also said to want at least a two-year extension now rather than deferring the issue until December.

Of course, even if the Congress agrees to only a short-term extension of the highway program this month, it does not mean that an international reform/highway funding plan will pass before the end of the year. Rather, it probably does guarantee that the next five months are spent debating the merits and structure of such a plan which could for a number of reasons fail to pass the Congress.

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Tax News & Views will be watching closely as the House and Senate grapple with the difficult politics here and will provide updates as developments occur.

Extenders to the head of the line?

In other news, there are rumors circulating on Capitol Hill that the Senate Finance Committee will try to mark up a tax extenders package during this work period – possibly as early as the week of July 20. Nothing has been announced officially and a Finance Committee spokesperson commenting on extenders to reporters July 8 said only that Chairman Hatch "hopes to act sooner rather than later."

For his part, Ways and Means Committee Chairman Ryan reaffirmed his commitment to moving an extenders bill in the fall at the July 9 *Politico* breakfast briefing, remarking that he "would love nothing more than to come back from the August recess with a plan in place to enact in September." Ryan also stated that he would like for an eventual extenders package to include permanent extensions of some of the now-expired tax deductions, credits, and incentives.

Since the 114th Congress convened in January, the House has approved – without offsets – permanent extensions of the research and experimentation credit, the deduction for state and local general sales taxes in lieu of the deduction for state and local income taxes, increased small-business expensing limits under section 179, tax relief provisions targeting S corporations, and tax incentives to promote charitable giving.

But those House-passed measures have not been taken up in the Senate, are generally opposed by congressional Democrats, and have been subject to veto threats by the White House. It is clear that there are difficult policy and political hurdles to surmount if congressional Republicans continue their push to make some of the expired tax provisions permanent, which in turn increases the odds that we may not see a resolution until later in 2015.

— Jon Traub, Jeff Kummer, Jon Almeras, Alex Brosseau, & Storme Sixeas
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