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Federal Tax Update: The Current Situation and the Prospects for Reform (Slides)

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cutting through complexity

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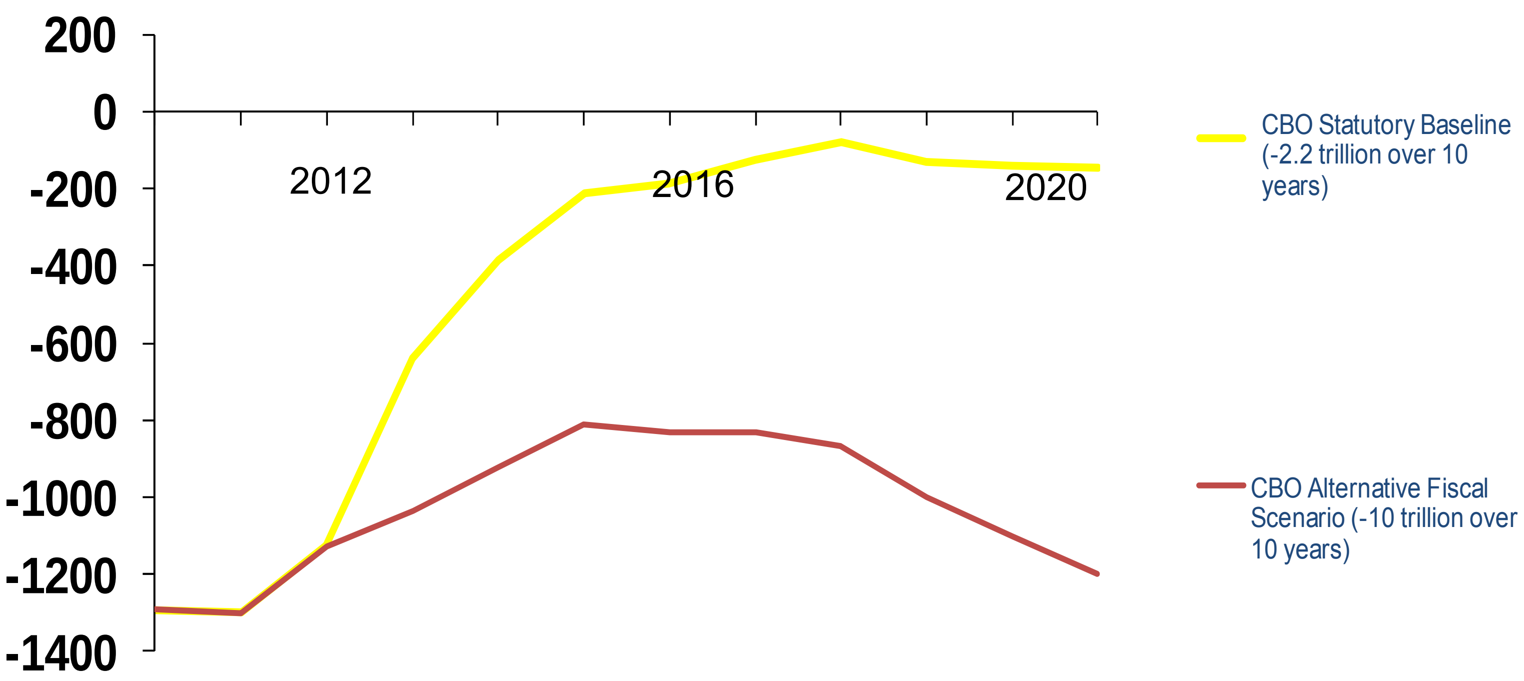
Agenda

- **The Post Election Lineup**
- **The Fiscal Cliff**
  - Unsustainable budget deficits
- **Tax Reform--What Is/Was/Will Be on the Table?**
- **What are the "Stakes"**
  - Individual
  - Business
    - Rate/Base
    - International
    - Pass-throughs/ C. Corps
- **Timing and Potential Outcomes**

The Election Outcome

- **President**
- **Senate**
  - Democrats increase their majority—55 (including 2 Independents)- 45
- **House**
  - Republicans retain control

The Fiscal Cliff --Total Budget Deficit – Total Dollars



Sources: CBO, Budget and Economic Outlook, fiscal years 2012 to 2022 (August 2012), Table 1.6; CBO alternative fiscal scenario assumes extension of doc fix, increase in discretionary spending at the rate of inflation, no enforcement of budget caps, extension of expiring tax provisions, and index AMT for inflation, as well as the extra interest costs associated with each.

The Fiscal Cliff At The End of 2012

- All 2001-2003 tax cuts expire
- AMT “patch” expires
- “Extenders” have expired
- Payroll tax cut expires
- Many unemployment benefits expire
- “Doc fix” expires
- Sequestration takes effect in FY13
- Debt ceiling may be reached

The Fiscal Cliff--Factors That Will Affect the Outcome

- **Fiscal situation is daunting**
  - Delicate balance between encouraging economic recovery and controlling long-term deficit
    - CBO projections illustrate dilemma
      - Current law (expiration of tax cuts, failure to patch AMT, etc.) results in slow short term economic growth, long term fiscal stability
        - » Short term GDP decline of .5%, unemployment at 9.1% through 4th Q. 2013, public debt at 58% of GDP in 2022
      - Extension of tax cuts accelerates growth, creates unsustainable long term deficits
        - » Short term GDP increase of 1.7%, unemployment at 8% through 4th Q. 2013, public debt at 90% of GDP in 2022

Source: CBO, Budget and Economic Outlook; Fiscal Years 2012 to 2022 (August 2012)

The Fiscal Cliff--Factors that Will Affect the Outcome

- **Individual tax issue must be addressed**
  - Only significant difference between the parties is whether tax rates increase on high income individuals
    - Who are high income individuals
    - What happens to dividend rates
  - Fate of extenders
    - Family and Business Tax Cut Act of 2012 reported by Senate Finance Committee
      - Major “extenders” retroactively renewed through 2013
      - $205 billion revenue cost is not offset
      - Not likely to move as a separate bill
      - Bonus depreciation not extended
- **Sequestration must be addressed**

What Is Was and Will Be on the Table?

- **President's FY 13 Budget**
  - Individual
  - Business/ The President's Framework for Business Tax Reform
- **The Path to Prosperity (House 2012 Budget Resolution)**
- **Camp/Enzi Corporate Rate Reduction/Territorial Proposals**
- **Fiscal Responsibility Commission (Simpson-Bowles)**
- **Debt Reduction Task Force (Domenici-Rivlin)**

President's FY2013 Budget - Major Individual Proposals

- **Sunset Bush Tax Cuts for Those With Incomes in Excess of $250,000**
  - Reinstate Pease and PEP
- **Limit value of itemized deductions to 28 percent**
- **Restore 2009 wealth transfer tax parameters**
  - Require consistency in value for transfer and income taxes
  - Modify rules on valuation discounts
  - Require a minimum term for GRATs
  - Limit duration of GST exemption
  - Coordinate income and transfer tax rules applicable to grantor trusts

President's FY13 Budget - Business Taxation

- **The President's Framework for Business Tax Reform**
  - Has to be read in conjunction with the Budget
  - Twenty-eight % marginal rate
    - Effective rate of 25% for manufacturing income
    - Retain and expand the R & E credit
  - Rejection of pure territorial tax system for non-U.S. income
    - Imposition of minimum tax on foreign income
  - Eliminate accelerated depreciation
  - Limit corporate interest deductibility
  - Expand scope of corporate tax

FY 2013 Budget - Major Domestic Business Tax Proposals

- **Extend “expensing” for one year**
- **Provide one year 10% credit for new jobs and wage increases**
- **Provide a 20% tax credit for expenses attributable to insourcing a U.S. trade or business**
- **Disallow deductions for expenses attributable to outsourcing a U.S. trade or business**
- **Modify the section 199 manufacturing deduction**
  - Eliminate the deduction for fossil fuel production
  - Increase deduction to 18% for “advanced technology property”
  - Increase general deduction to achieve at tax rate of 25% on manufacturing income
- **Expand and make R&E credit permanent**
- **Extend certain expiring provisions through 2012**
- **Repeal LIFO and LCM method of accounting for inventories**
  - Ten year transition for LIFO, 4 for LCM
- **Tax carried interests as ordinary income**
- **Repeal oil and gas and coal (fossil-fuel) preferences**

FY 2013 Budget - Major International Tax Proposals

- Minimum tax on foreign income
- Defer deduction of interest expense related to deferred foreign-source income
- Determine foreign tax credit on a pooled basis
- Tax currently “excess” returns associated with transfers of intangibles to a related CFC subject to a low foreign effective tax rate
- Clarify the definition of intangible property to include workforce in place, goodwill and going concern value for transfer pricing and section 367(d) purposes
- Modify the tax rules for dual capacity taxpayers to limit tax credit to host country generally applicable income tax rate
- Limit earnings stripped by expatriated entities

The Principal Components of the Camp Discussion Draft and Enzi Bill

- **Maximum corporate rate of 25 percent**
- **Exemption of 95 percent of dividends attributable to active business conducted by a 10 percent owned corporate subsidiary**
  - Treatment of 10/50 companies
  - Treatment of branches
  - Expenses allocable to exempt income
    - Sale of CFC stock
- **Subpart F income**
  - Active financing income
- **Base erosion alternatives**
  - Excess returns from transferred intangibles
  - Low-taxed cross border foreign income treated as Subpart F income
  - Foreign intangible income treated as Subpart F income but taxed at preferential rate
  - Deduction for foreign income derived from a trade or business in the U.S.
- **Thin capitalization/interest allocation**
- **Repatriation**

Fiscal Responsibility Commission

- **Individual Taxes (Illustrative Proposal)**
  - Three brackets—12/22/28
  - Repeal AMT, Pease and PEP
  - Capital gains and dividends taxed at ordinary rates
  - Maintain current law (or an equivalent) for the EITC and Child Tax Credit
  - 12 percent non-refundable tax credit for mortgage interest on mortgages below $500,000
  - Cap and then phase out employer provided health insurance
  - 12 percent non-refundable tax credit for charitable contributions in excess of 2 percent of AGI
  - Eliminate exclusion for newly issued state and municipal bonds
  - Consolidate and cap retirement accounts
  - Eliminate all other income tax expenditures

Fiscal Responsibility Commission

- **Business Taxes**
  - One Bracket- 28%
  - Eliminate
    - Domestic Production Credit
    - LIFO
    - General Business Credits
    - “Other” tax expenditures
  - Foreign source income
    - Active Income taxed on territorial basis
    - Current law for passive income
      - No VAT

The Debt Reduction Task Force

- **Major Individual Tax Recommendations**
  - Two brackets—17/27 percent
  - Capital gains and dividends taxed as ordinary income
  - Reform EITC
  - 15 percent refundable credit for mortgage interest and charitable deductions
  - Eliminate deduction for state and local taxes
  - 15 percent refundable tax credit for retirement savings contributions up to lesser of 20 percent of earnings or $20,000
  - Include 100 percent of Social Security benefits in income with 15 percent tax credit of individual's social security benefits plus a credit equal to 15 percent of the standard deduction
  - Allow deduction of miscellaneous itemized deductions in excess of 5 percent of AGI

Debt Reduction Task Force

- **Corporate Tax**
  - Corporate rate of 27%
  - No territorial tax
  - Eliminate tax expenditures

- **Establish a 6.5% VAT**

The Stakes in Reforming Individual Taxation

- **What are the goals?**
  - Revenue neutrality?
  - Distributional neutrality?
- **What is the debate about?**
  - Rates
  - Base
  - Distribution

The Stakes In Reforming Business Taxation

- **Revenue**
  - FY12- $251b., 10% of total federal revenue

- **“Competitiveness”**
  - Standard of living v. multinational competitiveness“
    - The goal of any reform of our international tax system should be to advance the [national] welfare of the United States.” John M. Samuels, “American Tax Isolationism,” Tax Notes, June 29, 2009

- **Revenue neutrality is generally accepted as best possible outcome for business**

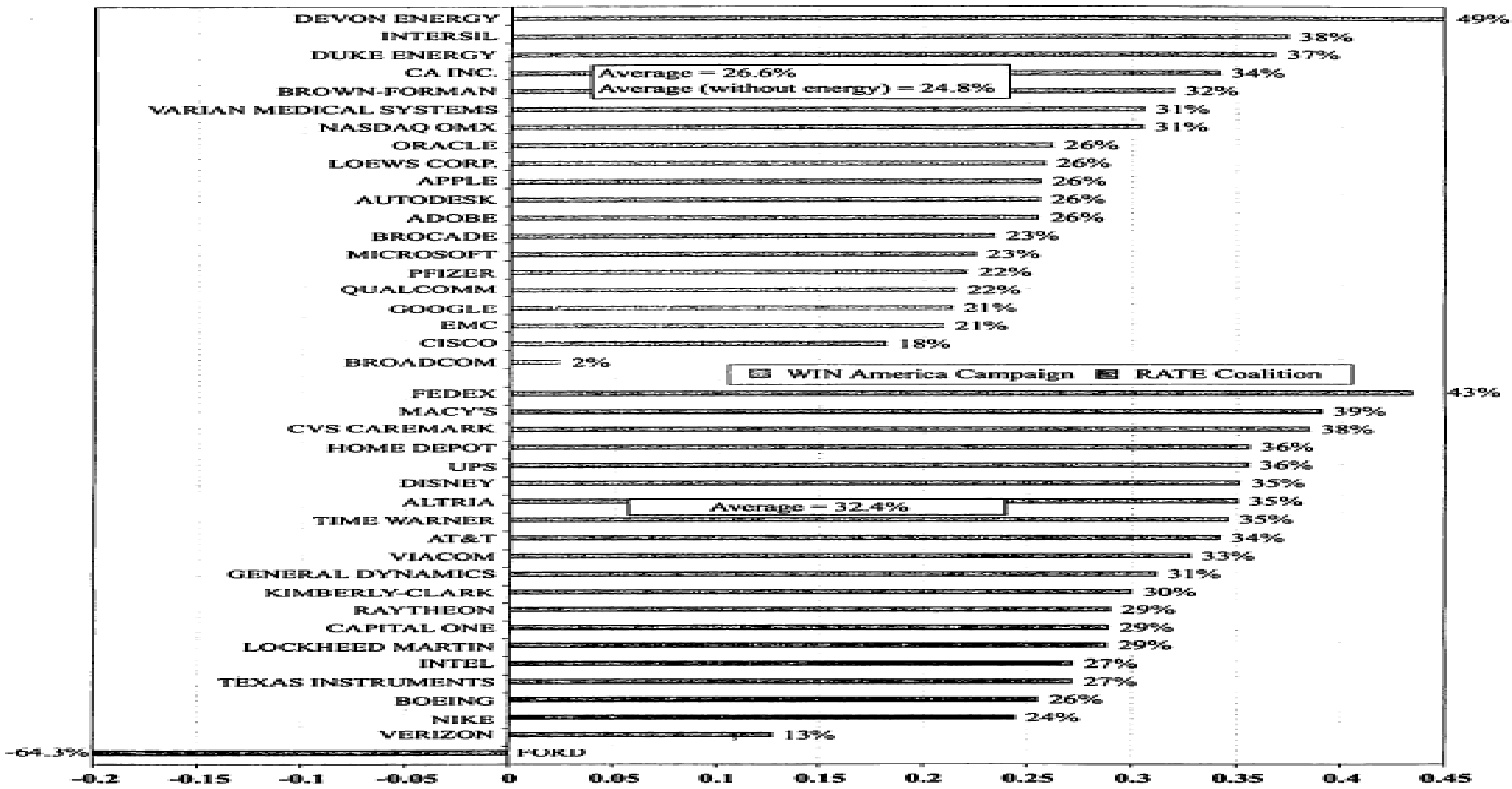
Source: Joint Committee on Taxation Memorandum, October 27, 2011

The Stakes In Reforming Business Taxation – cont'd

- **Rate v. Base**
  - Base broadening/rate reduction
    - Winners and losers
      - Domestics v. multinationals
      - Manufacturing v. other sectors
      - "C" Corporations v. pass-throughs
    - JCT has estimated 28% revenue neutral rate based on the elimination of **domestic** tax preferences applicable to corporations only
      - Rate could go lower if the tax preferences claimed by pass-through entities were also eliminated
    - Administration 28% rate depends on using international reforms plus additional revenue sources
      - Expand corporate tax to include "large" pass-through entities
      - Limit C corporation interest deductibility ("thin capitalization" rules)

Source: Joint Committee on Taxation Memorandum, October 27, 2011

Worldwide Effective Tax Rate
RATE Coalition vs. WIN America Campaign



Source: Martin Sullivan Calculations 134 Tax Notes 1486 (March 19, 2012)

Joint Committee Very Preliminary Estimate of Revenue Lost by Reducing the Corporate Rate to 28 Percent and the Revenue Gained by Repealing Certain Tax Expenditures for All Business Income - 2012-2021

Reduction in corporate rate to 28 %	**-717.5 b**
Interaction with corporate rate change	**-243.0 b**
<u>Revenue Gain of Selected Tax Expenditures</u>	
U.S. manufacturing deduction	**163.9 b**
Research and experimentation credit	**160.2 b**
LIFO and LCM	**72.6 b**
Accelerated cost recovery	**724.1 b**
Oil and gas and fossil fuel production incentives	**24.2 b**
Low income housing credit	**6.0 b**
Municipal bond interest exclusion	**34.8 b**
Like kind exchanges	**18.2 b**

Source: Joint Committee on Taxation Memorandum, October 27, 2011

The Stakes n Reforming Business Taxation---cont'd

- **Rate v. Base cont'd**
  - Other "base broadeners" come into play
    - Changes to accounting rules
    - Changes to other cost recovery rules
    - Limitations on the use of operating loss and tax credit carryovers
    - Limitations on the use of acquired tax losses and carryovers
- **Taxation of non-U.S. source income**
  - All multinationals lose if international preferences may be used to reduce overall rate (Obama)
  - Some win and some lose if non-U.S. source income rules are revised on a revenue neutral basis (Camp/Enzi)
- **Pass-Throughs v. Corps**
  - 70 percent of U.S. business income is earned by pass-throughs
  - Elimination of business tax preferences results in a tax increase for this sector
  - Creating parity is difficult
- **No consensus in the business community**

Timing and Potential Outcomes

- **The Effect of the Election**
- **The comparison to 1986**
  - Treasury Studies
  - Executive leadership
- **Timing**

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How to Think About Real Tax Reform

By Harry L. Gutman

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The author thanks Bennett Minton for invaluable research assistance.

This report exposes tax reform misconceptions and provides basic facts and analytic tools to assist the reader in reaching an informed decision about the real trade-offs and appropriate outcomes in the tax reform debate.

Table of Contents

The country faces a perilous fiscal situation. Federal Reserve Chair Ben Bernanke has described the end of this year as a ''fiscal cliff.'' The 2001 and 2003 tax cuts and the annual alternative minimum tax patch expire. So do the 2 percentage point payroll tax cut, many unemployment benefits, the Medicare reimbursement ''doc fix,'' and several other temporary tax provisions that are extended perennially. Sequestration mandated by last summer's Budget Control Act will become effective for fiscal 2013 and the existing national debt limit may have been reached. The Congressional Budget Office released a paper in May addressing the economic effects of reducing the fiscal restraint that is scheduled to occur in 2013.[1] It concluded that if all the scheduled tax increases and spending decreases actually occurred, the economy ''would probably be judged to be in recession.''[2]

Balancing short-term economic recovery needs with long-term deficit reduction is a daunting task. Too much fiscal contraction can jeopardize economic recovery. Failure to address the long-term issues will put the country on an unsustainable fiscal track. Those are problems a lame-duck Congress must address.

Douglas Elmendorf, head of the CBO, said recently that increasing tax revenues by one-sixth or reducing entitlement spending by one-fourth could, if done separately, put the country on a sustainable fiscal path.[3] But anyone who has tried to quantify precisely what it would take to achieve those objectives understands the practical and political improbability of that outcome. Consequently, the consensus of most objective observers is that revenues need to increase and spending, particularly entitlement spending, must be reduced.[4] This report is about revenues.

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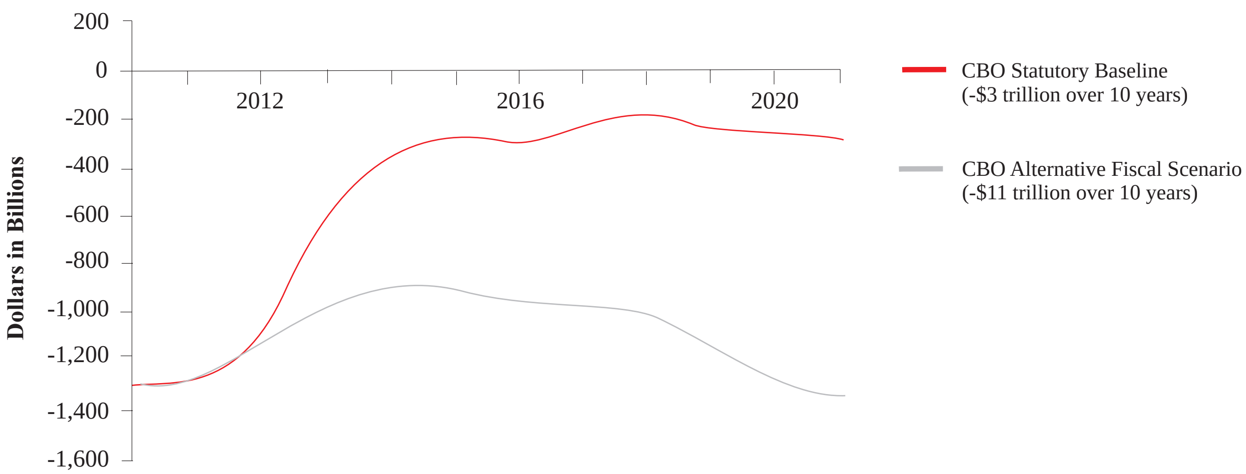
[1]CBO, ''Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013'' (May 2012), *Doc 2012-11046*, *2012 TNT 100-32*.

[2]*Id.* at 2.

[3]Douglas Elmendorf, ''Back to the Classroom: A Visit to Harvard University,'' CBO (Feb. 24, 2012), *available at* http://www.cbo.gov/publication/43017.

[4]*See, e.g.*, testimony of former Sen. Pete Domenici and Dr. Alice Rivlin before the Senate Finance Committee (June 19, 2012), *Doc 2012-13104*, *2012 TNT 119-38*.

Figure 1. Total Budget Deficit — Total Dollars



Source: CBO, "The Budget and Economic Outlook: Fiscal Years 2012 to 2022 (January 2012), Table 1.7, *Doc 2012-1855*, *2012 TNT 21-26*; CBO alternative fiscal scenario assumes extension of doc fix, increase in discretionary spending at the rate of inflation, no enforcement of budget caps, extension of expiring tax provisions, and index AMT for inflation, as well as the extra interest costs associated with each.

I. Introduction

The recently published Hamilton Project report, "A Dozen Economic Facts About Tax Reform," stated in its introduction that "today's tax reform debates are often based on misconceptions."[5] That is an understatement. As my former employer Sen. Pat Moynihan was fond of saying, "Everyone is entitled to his own opinion, but not to his own facts."[6] The purpose of this report is to expose some of those misconceptions and provide some basic facts and tools to help reach an informed opinion about the real trade-offs and appropriate outcomes affecting the role taxes should play in mitigating the daunting fiscal challenge.[7]

The first section will provide a macro context, reviewing briefly the most recent CBO budget forecasts, comparing the tax burden in the United States with that of the other OECD countries, and finally looking at the revenue sources in all the OECD countries. The next section will describe the policy objectives of any tax regime: equity, efficiency, and administrability. It will compare two fundamental tax bases: income and consumption. Next, it will define and discuss the tax expenditure concept, which provides a framework from which to analyze both the extent to which government spending is accomplished through the tax system and the benefits and deficiencies of using the tax system in that way. The next two sections will comment on the taxation of business income and the wealth transfer tax. The final section will describe the practical constraints on legislative action. The specific congressional procedural rules that govern the consideration of tax legislation, as well as the need for executive leadership, will be addressed.

The discussion will assume that because of the budget situation any tax changes will have to be revenue neutral at a minimum. In other words, any tax reductions will have to be offset by equivalent tax increases. Thus, the tax reform world will resemble a poker game, which is revenue neutral because a finite amount of money comes to the game and the same amount leaves, but in different pockets. The real question is who will pay.

II. Macro Data

The CBO budget projections provide the economic context for this discussion. They are the projections that govern congressional consideration of tax and spending legislation. Figure 1 shows the CBO projection of the deficit based on two different sets of assumptions. The upper line represents the CBO projections determined under the baseline it is required to use under the Congressional Budget and Impoundment Control Act of 1974 (Budget Act).[8]

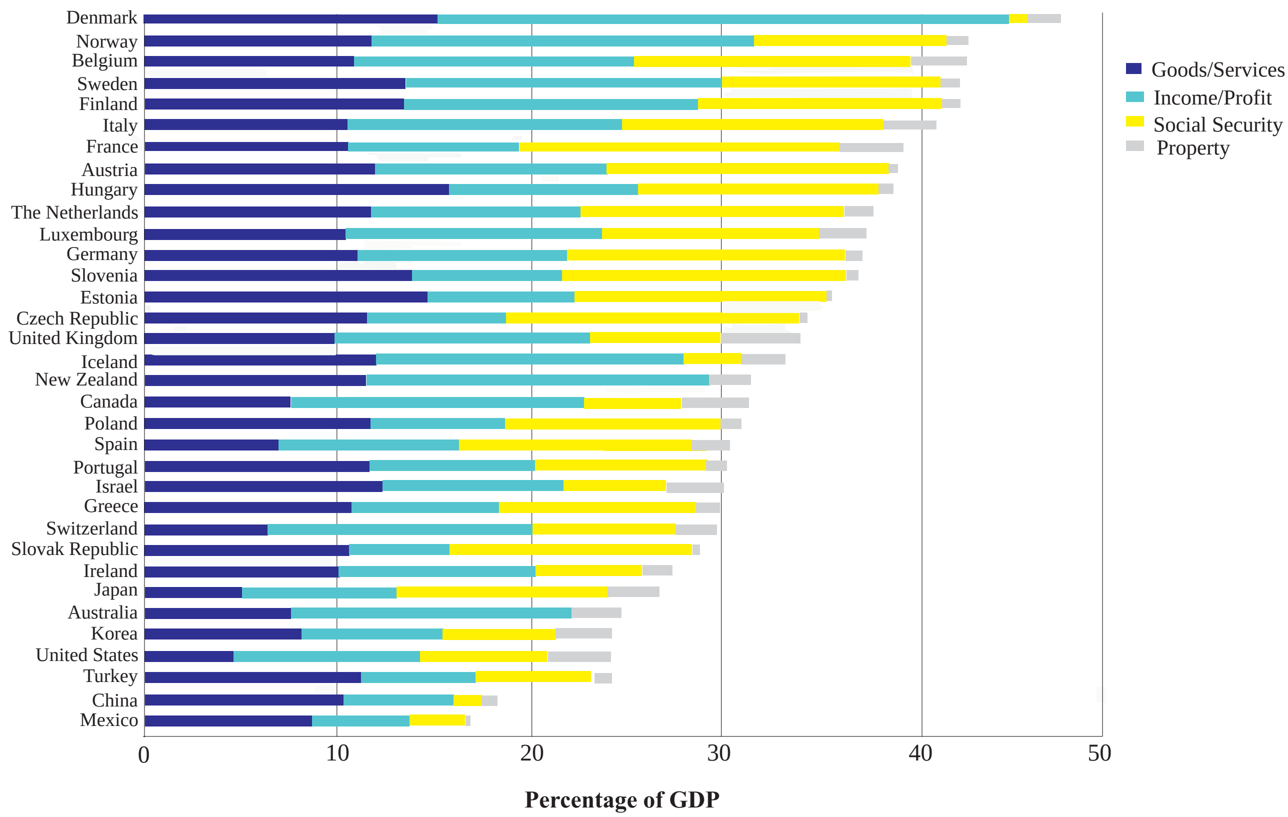
[5]Hamilton Project, "A Dozen Economic Facts About Tax Reform" (May 2012).

[6]*Id.*

[7]*See also* S. Douglas Hopkins, "Factual Distortions Derail Productive Debate on Tax Reform," *Tax Notes*, June 18, 2012, p. 1517, *Doc 2012-11567*, or *2012 TNT 119-7*.

[8]P.L. 93-344.

Figure 2. Types of Tax Revenue as Share of GDP, 2009



Source: OECD.

That baseline is, in substance, current law.[9] Recognizing that is not likely to occur, the CBO has created an alternative fiscal scenario, under which all the expiring tax cuts are extended, spending caps are not enforced, the doc fix is renewed, and other technical changes assumed.[10] That is the lower line on the chart — a cumulative $11 trillion deficit over the next 10 years. The CBO has described the latter fiscal path as unsustainable. Under it, public debt rises to 93.2 percent of GDP by 2022. It is also important to note, while not shown on the figure, that federal tax revenues are currently at about 15 percent of GDP, well below the recent historical average of approximately 18 percent.[11]

Figure 2 is a terrific Moynihan document. It shows total tax revenue by types as a percentage of GDP in the OECD countries.[12] The United States is ranked 31st out of 34. Some may think that is the right place, but the U.S. tax burden is actually well below that of the other OECD countries.

Figure 3 shows the specific tax sources of the OECD countries by percentage of GDP in 2008.[13] The United States is about the same in income taxes, lower in Social Security taxes (to be expected because of the more extensive social safety nets in many of the OECD countries), and not even close in consumption taxes. In fact, the United States is the only country out of 163 surveyed that does not have a national consumption tax.

While that anticipates the end of the story, you do not have to be too clever to connect the dots of a fiscal dilemma, relatively low taxation, and an untapped revenue source.

III. Tax System Design

When policymakers confront the question of what a tax system should look like they focus on three criteria: equity, efficiency, and administrability. Equity reflects judgments as to the appropriate distribution of the tax burden. Efficiency means that

[9]CBO, "The 2012 Long-Term Budget Outlook," at 2 (June 2012), *Doc 2012-12113*, *2012 TNT 109-23*.

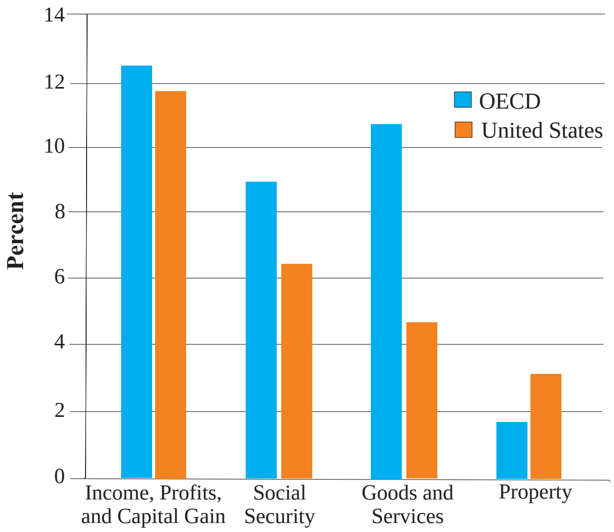
[10]*Id.* at 3.

[11]*Id.* at 78.

[12]OECD, "Revenue Statistics 1965-2010," Table 2, at 82 (2011), *available at* http://dx.doi.org/10.1707/883932508699.

[13]*Id.*

Figure 3. Tax Source as Share of GDP, 2008



Source: OECD.

the system should be neutral regarding decision-making. Administrability means that the system should impose the least possible compliance and administrative costs. Our existing system is a disgrace when measured against each of those criteria.

A. Equity

The appropriate distribution of the tax burden is a subjective decision to be made by our elected representatives. We would see more sensible outcomes if politicians made some effort to understand it rather than mouthing platitudes that score political points but are demonstrably wrong.

We start with the falsehood du jour — ''only 46 percent of American households pay federal tax.'' Forty-six percent is an estimate by the Brookings-Urban Institute Tax Policy Center, but it represents households that did not have income tax liability in 2011.[14] Moreover, the number is anomalous because incomes were depressed in 2011 and two temporary tax cuts that were enacted in the American Recovery and Reinvestment Act of 2009 removed many from the tax rolls. In 2007, before the economic downturn, 60 percent of households paid income taxes.[15]

A more accurate measure would take into account the payroll tax. When that is done, the number of households paying federal tax was 83 percent in 2009 and 86 percent in 2007.[16] Most of those who pay no federal tax are elderly, disabled, students, or unemployed.

Finally, those numbers do not take state and local taxes into account. Recent data show that in 2011 the bottom fifth of households paid 12.3 percent of their incomes in state and local taxes.[17] When all taxes are taken into account, the bottom one-fifth of households pay an average of 16 percent of their incomes in taxes.[18] That is quite a different distributional picture from that suggested by some ''scholars'' and television commentators — as well as some unnamed senators who surely know better.

One other word about the distribution of federal income tax liability: Over the last 50 years, tax rates for the wealthiest 1 percent of Americans have declined 40 percent while tax rates for the rest of the population have remained roughly the same.[19] Since 1979, earnings for that top 1 percent have risen 250 percent.[20] Those who have received the largest income gains have also seen the largest tax cuts, thus materially reducing the overall progressivity of the income tax. So, while it is true that the share of taxes paid by the top 1 percent has increased, it is because their share of income has also increased. The top 1 percent of Americans paid 28 percent of federal income tax revenues in 2007 (compared with 15.4 percent in 1979).[21] That group's share of income was 19.4 of total U.S. income in 2007 as compared with 9.3 percent in 1979.[22] Overall, a distribution of federal income taxes across all households for 2011 would show mild progressivity, with the effective tax rate as a percentage of gross income on the highest quintile at 14.9 percent.[23] The rate for the top 1 percent was 20.3 — and for the top 0.1 percent it was 19.8.[24]

Whether that distribution is equitable is a social judgment. But that judgment should be based on a comprehensive analysis of the tax burden and not isolated segments.

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[14] Chuck Marr and Chye-Ching Huang, ''Misconceptions and Realities About Who Pays Taxes,'' Center on Budget and Policy Priorities (Apr. 11, 2012), *Doc 2012-7669*, *2012 TNT 71-33*.

[15] *Id.*

[16] Tax Policy Center, ''Tax Units With Zero or Negative Tax Liability, Current Law, 2004-2011,'' T11-0173 (June 14, 2011), *Doc 2011-13102*, *2011 TNT 116-43*.

[17] Marr and Huang, *supra* note 14.

[18] *Id.*

[19] Michael Greenstone and Adam Looney, ''Just How Progressive Is the U.S. Tax Code?'' The Hamilton Project (Apr. 13, 2012), *Doc 2012-7934*, *2012 TNT 73-60*.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] Tax Policy Center, ''Average Effective Federal Tax Rates by Cash Income Percentiles, 2011; Baseline: Current Law,'' T12-0018 (Feb. 8, 2012), *Doc 2012-2600*, *2012 TNT 27-34*.

[24] *Id.*

B. Efficiency

Now we turn to economics and economists. To be sure, economists can add value to this debate, but remember — they would say that the way to open a can on a deserted island is to assume a can opener. They would also tell you that a person who fought in the Civil War and one who paid $300 to have someone fight for him had an equivalent experience. The point is that economic theory does not always produce the optimal societal result when evaluated against experience, intuition, and common sense.

The ideal tax system is neutral as to its economic effects. Our system fails that test. It is a hybrid system that contains some elements of a consumption tax, particularly our treatment of retirement savings, and some elements of an income tax. It affects economic behavior and is used as a substitute delivery mechanism for a multitude of government programs ranging from low-income support to subsidies for specific activities. As a consequence, it is an administrative and compliance nightmare.

The conceptual starting point is to identify the tax base. As a practical matter there are two choices: income or consumption, and they are related (I = C + S). Thus, the income tax base includes consumption plus savings. The consumption tax base equals income minus savings. A different way of expressing that relationship is to say that a consumption tax exempts from the tax base the normal return on an investment, a formulation familiar to finance experts as the ''immediate deduction-yield exemption equivalence.''[25] For many economists, that fact — the exemption of the normal return from invested capital from the tax base — is a fundamental reason to prefer consumption rather than income as the tax base. From an efficiency perspective, the consumption tax removes the tax wedge from investment decisions and creates a more level decision-making field.

However, that is where efficiency as a goal collides with equity considerations. Another way of looking at a consumption tax is to observe that a consumption tax is paid only by wage earners and those who aren't saving. The latter group is those who borrow heavily — perhaps students with high debt burdens — and more importantly, those who are consuming their savings — retirees. One can question the fairness of a tax system whose burden is borne by students, wage earners, and retirees. And there is nothing secret about it — all one need to do is look at the simple tax form that would be filed under Dick Armey's ''flat'' tax.[26] There is no category for interest, dividends, and capital gain. It is hard to believe that the American public would accept that distribution of the tax burden, unless it was accompanied by some form of tax on capital.

There is nothing magic about a flat tax. The term simply describes a system in which a single rate is imposed on a specified tax base. The real question is what the base should be. The Forbes/Armey tax base was consumption. Take that observation one step further: If that is a good tax, so is a VAT because the base of both is consumption — they are just collected differently. One suspects that the attraction of the Forbes/Armey flat tax is that it is advertised as a replacement for the income tax and the VAT is viewed as an add-on tax. That may be true as a political matter, but it cannot obscure the fact that the taxes are economically identical.

No matter which tax base is chosen, all theorists agree that as an efficiency matter the tax should include the entire base. The bases of our income taxes are far from comprehensive. That has serious equity and economic consequences, most of which have not been empirically quantified.

So how to think about that? The term ''tax expenditure'' is the tool we will use. In the 1960s Treasury Assistant Secretary for Tax Policy Stanley Surrey was searching for a term to describe the provisions in the tax code that were not necessary to define income. The purpose of the exercise was to identify them — not to make a judgment about their merit — so that they could be subjected to a traditional cost-benefit analysis.[27]

Tax expenditures were defined as ''revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.''[28] For example, the home mortgage interest deduction is a tax expenditure. Why? An income tax does not permit the deduction of expenses that produce nontaxed income. Home mortgage interest is an expense related to exempt income — the imputed rental value of the home it finances. Thus, it is a tax expenditure. Now, turn it around and analyze the deduction as a government spending program. It is available only to those who own their homes, not to those who rent. Thus, it encourages homeownership. But it is available only to homeowners who itemize their deductions — only 30 percent of the taxpayers who pay income

[25] *See* Michael J. Graetz, ''Implementing a Progressive Consumption Tax,'' 92 *Harv. L. Rev.* 1575, 1598-1600 (1979).

[26] Senate Budget Committee hearing on income tax reform, at 291 (Feb. 22, 1995).

[27] *See generally* Stanley Surrey, *Pathways to Tax Reform* (1976).

[28] Budget Act, section 3(3).

tax.[29] Finally, the value of the deduction increases as the taxpayer's tax bracket increases. When translated into a government program to subsidize housing, it is a program that is available only to a limited number of homeowners, and the wealthier they are, the bigger the benefit. If it were a direct spending program to encourage homeownership, is that how Congress would design it?

That example illustrates an important point about tax expenditures that provide deductions or exclusions from income: They are worth more the higher a beneficiary's tax bracket. That may be how some spending programs would be designed, but not many.

The tax expenditure concept has become virtually universally accepted, not necessarily by name but by the recognition that those provisions are the source of disguised spending and distortions in the tax base. The Joint Committee on Taxation and the Office of Management and Budget are required by the Budget Act to publish a list of tax expenditures annually.[30] The list published in 1972 contained 62 items.[31] Today's list has more than 280.[32]

The total static revenue loss attributable to tax expenditures in 2011 was $1.3 trillion (compared with $63.2 billion in 1972).[33] The entire federal direct expenditure budget in 2011 was $3.6 trillion.[34] In other words, 26 percent of federal spending last year was accomplished through the tax code. And different tax expenditures affect different groups. The earned income tax credit, child tax credit, and dependent care credit principally benefit the bottom 40 percent; retirement savings incentives the top 20 percent; and capital gains and dividend preferences the top 1 percent.[35]

Significant spending reductions (and increased revenues) could occur through the repeal or reduction of those tax expenditures. And that is how most tax reformers want to finance rate reduction. But we must be clear about how much can realistically be accomplished by that form of base broadening. The largest individual tax expenditures are retirement savings incentives, the exclusion for employer-provided health insurance, the deduction for state and local taxes, the home mortgage interest deduction, the charitable contribution deduction, and the step-up in basis at death. Apart from the political constituency that supports each of those items, one must recognize that many of them are spending programs that cannot simply be cut off without real economic consequences. The notion that tax reductions can be funded by eliminating many of them is naive.[36] However, they could be redesigned to provide benefits in a more rational way; for example, turning them into refundable credits that phase out as incomes rise[37] or, as the Obama administration has proposed, limiting the tax benefit to 28 percent.

C. Administrability

There is universal recognition that the complexity of the tax code has led to a system that is almost impossible to administer efficiently. The call for simplification is universal — until specifics are put on the table, and then consensus disappears. IRS funding is being decreased while Congress is enacting more spending programs for the Service to administer, and when international tax minimization is becoming increasingly prevalent. It should be obvious that unless and until the tax structure is streamlined, an administrable system is a pipe dream.

IV. Business Taxation

Virtually no day passes without some mention in the business press about business tax reform. The president's "Framework for Business Tax Reform" described the problem succinctly and accurately:

> The United States has a relatively narrow corporate tax base compared to other countries — a tax base reduced by loopholes, tax expenditures and tax planning. This is combined with a statutory corporate rate that will soon be the highest among advanced countries. As a result of this combination of a relatively narrow tax base and a high statutory rate, the U.S. tax system is uncompetitive and inefficient. The system distorts choices such as where to produce, what to invest in, how to finance a business, and what business form to use. And it does too little to encourage job creation and investment in the United States while allowing firms to benefit from incentives to locate production and shift profits overseas.

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[29]Benjamin H. Harris and Daniel Baneman, "Who Itemizes Deductions?" *Tax Notes*, Jan. 17, 2011, p. 345.

[30]Budget Act, section 3(3).

[31]*See* Surrey, *supra* note 27, at 8.

[32]JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015," JCS-1-12 (Jan. 17, 2012), *Doc 2012-894*, *2012 TNT 11-21*.

[33]Donald Marron, "How Big Are Tax Preferences? Try 1.3 Trillion," *available at* http://www.csmonitor.com/business/tax-vox/2012/0409/How-big-are-tax-preferences-Try-1.3-trillion.

[34]CBO, "The Budget and Economic Outlook: Fiscal Years 2012 to 2022," at xii (Jan. 2012), *Doc 2012-1855*, *2012 TNT 21-26*.

[35]Hamilton Project, *supra* note 5, at 15.

[36]*See, e.g.*, John L. Buckley, "Tax Expenditure Reform: Some Common Misconceptions," *Tax Notes*, July 18, 2011, p. 255, *Doc 2011-13056*, or *2011 TNT 138-6*.

[37]*See, e.g.*, Bipartisan Policy Center, "The Debt Reduction Task Force, Restoring America's Future" (Nov. 2010), *Doc 2010-24611*, *2010 TNT 222-29*.

The system is also too complicated — especially for small businesses.[38]

Like the personal income tax, resolution of those problems cannot occur in a vacuum. The same fiscal challenges dictate that any responsible reformation of business taxation must be revenue neutral, at a minimum. Moreover, that more than 70 percent of net business income in the United States is earned by entities that are not subject to the corporate tax adds another complication to the equation.[39] The latter makes it clear that reform of business taxation cannot logically occur without a concurrent examination of individual taxation.

To date, the business tax reform discussion has been long on rhetoric and short on detail. That is not surprising. In the zero-sum game that is created by budget constraints, the expressed goals may be unattainable without an additional revenue source, specifically a national consumption tax. Discussion of that alternative by those who would have to enact it is viewed as political suicide. Hence, we have mostly aspirational objectives articulated by the administration, the chairs of the House Ways and Means and Budget committees, the president's National Commission on Fiscal Responsibility and Reform (the Bowles-Simpson commission), and the report of the Debt Reduction Task Force, commissioned by the Bipartisan Policy Center. However, without detailed, comprehensive proposals, one is left to speculate about the impact of change on any of the shortcomings described above.

A. The Proposals

1. The framework. The administration has outlined a business tax reform plan that would reduce the corporate tax rate from 35 to 28 percent. The revenue cost of that rate reduction would be offset by repeal or substantial modification of several tax preferences and incentives, as well as several more fundamental changes in the taxation of business income. The framework must be read in conjunction with the budget proposals described in greater detail in Treasury's "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals,"[40] which are discussed below. (An asterisk indicates an item is included in the General Explanation.) The latter document provides additional detail to several of the proposals mentioned in the framework.

The major aspects of the framework would:

- reduce the highest corporate rate to 28 percent;
- increase the domestic production deduction to 10.7 percent, thereby providing a 25 percent maximum rate for domestic manufacturing income, with an 18 percent deduction for income attributable to advanced technology property, paid for by excluding income from oil and gas and other fossil fuel production and some other non-manufacturing activities from the domestic production deduction;
- make the research and experimentation tax credit permanent and increase the rate of the alternative simplified research credit from 14 to 17 percent;
- make permanent and refundable the tax credit for renewable energy generation*[41] and broaden the tax base by eliminating dozens of tax expenditures, such as:
  - last-in, first-out inventory accounting, with a 10-year transition*;
  - oil and gas and fossil fuel production preferences*; and
  - special depreciation rules for noncommercial aircraft*;
- impose a minimum tax on offshore income earned by subsidiaries of U.S. corporations;
- deny deductions for expenses attributable to moving operations abroad;
- tax the excess profits associated with intangibles that have been transferred to low-tax jurisdictions*; and
- deny deductions for interest attributable to overseas investment until the related income is taxed in the United States.*

The framework implicitly acknowledges that the enactment of the foregoing proposals would not be revenue neutral. It suggests three other items to address the revenue shortfall:

- end accelerated deprecation;
- limit the deductibility of corporate interest; and
- establish greater parity in the tax treatment of large corporations and large passthrough entities through either expanding the reach of the corporate tax or integrating the corporate and individual taxes.*[42]

2. The administration's fiscal 2013 revenue proposals.[43] Most commentary has focused on the framework since its release. However, as part of the

[38]The White House and Treasury, "The President's Framework for Business Tax Reform," at 1 (Feb. 22, 2012), *Doc 2012-3711*, *2012 TNT 36-18* (the framework).

[39]*Id.* at 7.

[40]Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals" (Feb. 2012), *Doc 2012-2947*, *2012 TNT 30-32* (the General Explanation).

[41]This differs from the budget proposal in which the credit was extended only for property placed in service in 2013. *Id.* at 35.

[42]The latter would result in a revenue loss that would have to be offset in other ways.

[43]*See generally* the General Explanation, *supra* note 40.

fiscal 2013 budget, the administration made more than 125 specific revenue proposals to provide incentives for job creation and growth, tax cuts for families, initiatives to provide regional growth, reduction of the tax gap, and structural simplification that reach well beyond the taxation of corporate income.

The major proposals in addition to those mentioned in the framework include:

- extending the Bush-era individual tax provisions for those with incomes below $250,000, and reinstate the 36 and 39.6 percent rates and the Pease overall limitation on the ability to claim itemized deductions and the personal exemption phaseout for upper-income taxpayers;
- taxing qualified dividends as ordinary income;
- taxing long-term capital gains at a 20 percent rate for upper-income taxpayers;
- limiting the value of itemized deductions and specified above-the-line deductions and exclusions to 28 percent;
- restoring the wealth transfer tax to its 2009 levels with a maximum rate of 45 percent, a $3.5 million exclusion for estate and generation-skipping transfer taxes, and a $1 million exclusion for gift taxes;
- extending the 100 percent depreciation deduction through 2012;
- extending other expired provisions, such as the subpart F active financing income exception and the controlled foreign corporation "look-through" rule through 2012;
- providing a temporary 10 percent incremental new jobs and wage credit for 2012;
- providing a suite of tax benefits for energy-conserving expenditures;
- determining the foreign tax credit on a pooling basis;
- modifying the tax rules for some dual-capacity taxpayers;
- imposing a financial crisis responsibility fee of 17 basis points of covered liabilities;
- repealing lower of cost or market inventory accounting with a four-year transition; and
- clarifying the worker classification rules.

3. The 'Buffett rule.'[44] The administration has also proposed a 30 percent minimum tax on households with more than $1 million of income. Treasury Secretary Timothy Geithner has said that the "Buffett rule" would replace the AMT. A bill that incorporates the concept has been introduced by Sen. Sheldon Whitehouse, D-R.I.[45] The JCT has scored the bill as raising $46.7 billion over 10 years, far short of the amount needed to fund a repeal of the AMT.[46] The Senate has rejected attempts to bring the legislation up for consideration.

4. The path to prosperity (the 'Ryan budget').[47] The House has adopted the budget proposals of the Budget Committee. The budget calls for a maximum corporate rate of 25 percent, broadening "the tax base to maintain revenue growth at a level consistent with current tax policy" and shifting to a territorial system for taxing income earned outside the United States.[48] The budget offers no practical guidance because it fails to quantify its revenue growth target and does not indicate how the base should be broadened to attain that goal.

5. The Camp and Enzi proposals.[49] Ways and Means Committee Chair Dave Camp, R-Mich., has released a detailed proposal that proposes a participation exemption (territorial) system to address the treatment of business income earned outside the United States. He also would reduce the corporate tax rate to 25 percent. The committee summary states that the goal would be achieved on a revenue-neutral basis by broadening the corporate tax base. However, specific base-broadening provisions are not included in the draft.

The principal elements of the Camp draft are:

- a maximum corporate rate of 25 percent;
- exemption of 95 percent of dividends attributable to active business received by a 10 percent U.S. corporate shareholder from a CFC;
- treatment of branches as corporations;
- current taxation of highly mobile passive income;
- the alternative proposals to address base erosion;
- interest allocation rules; and
- taxation at 5.25 percent of all existing foreign earnings held offshore.

The Enzi bill is similar. The principal differences are for the base erosion alterative, the treatment of branches, the interest allocation provision, and the

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[44]The National Economic Council, "The Buffett Rule: A Basic Principle of Tax Fairness" (Apr. 2012), *Doc 2012-7488*, *2012 TNT 70-27*.

[45]S. 2059, Paying a Fair Share Act of 2012.

[46]JCT, Revenue Estimate, Mar. 20, 2012, *Doc 2012-5868*, *2012 TNT 55-30*.

[47]Paul Ryan, "The Path to Prosperity: A Blueprint for American Renewal, Fiscal Year 2013 Budget Resolution" (Mar. 20, 2012), *Doc 2012-5826*, *2012 TNT 55-22*.

[48]*Id.*

[49]Camp, Summary of Ways and Means Discussion Draft (Oct. 26, 2011), *Doc 2011-22575*, *2011 TNT 208-29*; S. 2091, the U.S. Job Creation and International Tax Reform Act of 2012, *Doc 2012-2804*, *2012 TNT 29-54*; Technical Explanation of the United States Job Creation and International Tax Reform Act of 2012 (Feb. 9, 2012), *Doc 2012-2828*, *2012 TNT 29-53*.

taxation of unrepatriated offshore earnings. Regarding the last, the bill would allow a 70 percent deduction for actual and electively deemed repatriations of offshore earnings.

6. The Cantor bill.[50] The Small Business Tax Cut Act, which has passed the House, would provide a one-year 20 percent deduction of ''qualified business income'' earned by entities with less than 500 employees, subject to a limit of half the wages to employees. The JCT has estimated the cost of the bill to be $46 billion and has commented that its effects on the economy would be ''so small as to be incalculable.''[51]

7. The National Commission on Fiscal Responsibility and Reform.[52] The presidentially appointed Bowles-Simpson commission recommended the following:

- a single corporate tax rate between 23 and 29 percent;
- elimination of all business tax expenditures;
- adoption of a territorial system for active foreign-source business income; and
- current taxation of foreign-source passive income.

8. The Debt Reduction Task Force.[53] The Debt Reduction Task Force, co-chaired by former Sen. Pete Domenici and Dr. Alice Rivlin, was created by the Bipartisan Policy Center, founded in 2007 by former Senate Majority Leaders Howard Baker, Bob Dole, Tom Daschle, and George Mitchell. Its November 2010 report recommended:

- a two-bracket corporate rate structure of 15 and 27 percent;
- elimination of many business tax expenditures;
- retention of accelerated methods of cost recovery;
- retention of current system of taxing foreign-source income; and
- a 6.5 percent deficit reduction sales tax (VAT).

V. The Unanswered Questions

While consistent in some respects, there are significant differences among the proposals. That lack of specificity raises several important questions, which can be grouped into three broad categories: the corporate rate and base, the taxation of foreign-source income, and the interaction of corporate and individual taxes.

A. The Corporate Rate and Base

Reduction of the corporate rate is very important. It will make the United States more attractive for foreign investment and will reduce incentives to move income offshore. All the proposals espouse a reduction of the corporate tax rate to between 25 and 29 percent. All the proposals also assume an outcome that is at least revenue neutral. The unanswered question is how they get there.

As noted earlier, the administration has proposed several specific base broadeners in both the framework and its budget. The administration would use revenue from its proposed international reforms to offset the cost of rate reductions and making the expanded research credit permanent. The additional benefit to domestic manufacturing is designed to be revenue neutral, with the revenue offset coming from the elimination of the deduction for non-manufacturing activity.

The administration has not provided any revenue estimate of the total cost of rate reduction and a permanent research credit. However, one can roughly estimate the cost by referring to two sources: the JCT very preliminary revenue table of October 27, 2011, provided to Ways and Means ranking minority member Sander M. Levin, D-Mich.,[54] and the JCT estimate of the cost of making the research credit permanent.[55] According to the JCT, a reduction of the corporate rate to 28 percent would cost $717.5 billion over 10 years, and interactions would reduce revenues by an additional $243 billion, for a total cost of $960.5 billion (or roughly $137 billion per point). The JCT has estimated the cost of research and experimentation permanence to be $99.3 billion. Thus, the total amount needed from base broadening is $1.06 trillion.

The enactment of all the base broadeners in the administration's budget would not come close to raising that amount. Indeed, according to the JCT, enacting all the suggested business base broadeners would raise roughly $287 billion.[56] Thus, the question is how much could be raised by enacting all or some of the additional revenue proposals that appeared in the framework: repealing accelerated cost recovery, limiting interest deductibility, expanding the corporate tax base to include large passthrough

[50]H.R. 9, the Small Business Tax Cut Act.

[51]H.R. Rep. 112-428, at 18 and 20.

[52]The National Commission on Fiscal Responsibility and Reform, ''The Moment of Truth'' (Dec. 2010), *Doc 2010-25486*, *2010 TNT 231-35*.

[53]*See supra* note 37.

[54]JCT, ''Estimated Revenue Effects of Corporate Tax Reform Revenue Raising Provisions That Repeal or Modify Tax Expenditures,'' tables 11-1 133 and 11-1 134 (Oct. 27, 2011), *Doc 2011-23034*, *2011 TNT 213-12*.

[55]JCT, ''Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposals,'' JCX-27-12 (Mar. 14, 2012), *Doc 2012-5410*, *2012 TNT 51-13*.

[56]*Id.*

entities, and imposing a minimum tax on foreign-source income. According to the JCT estimate provided to Levin, repeal of accelerated cost recovery for all businesses (which is a timing issue) would raise $724 billion over 10 years.[57] The administration has provided no details or numbers for the other three items, but they could certainly be designed in a way that would raise the amount needed to close the gap.

The explanation of Camp's proposal states that ''the rate reduction [to 25 percent] would be accomplished without increasing the deficit by broadening the tax base.''[58] Moreover, his reforms to the international tax sector are intended to be revenue neutral on their own: ''Domestic base broadening should [not] be used to finance international tax relief, and vice versa.''[59] Thus, for Camp, the crucial threshold is which domestic business tax preferences are to be eliminated to finance a rate reduction to 25 percent.

The JCT analysis indicates that repeal of all the domestic business tax preferences that are attributable to corporations (including the manufacturing deduction, the research and experimentation credit, and accelerated cost recovery) could pay for a rate reduction to 28 percent.[60] Additional repeal of the business tax preferences used by noncorporate taxpayers would raise an additional $300 billion, thus permitting a rate reduction to approximately 25.8 percent.[61] Likely transition relief is not reflected in the estimate, nor is expected taxpayer behavioral response taken into account in all cases.

The foregoing demonstrates that it is mathematically possible to offset a rate reduction to close to 25 percent — and there are many dials that can be adjusted to get there. However, mathematical possibility and political possibility are two entirely different animals. It is not likely that all the elements of the administration's plan would be enacted, nor is it likely that all business tax expenditures would be eliminated for all business taxpayers to fund the Camp proposal — and even if they were, undoubtedly there would be transition relief that would reduce the revenue that could be realized. The point is that short of repealing the laws of arithmetic, corporate rates cannot be reduced to the levels discussed by the politicians simply by reducing or eliminating business tax preferences.

It is, of course, possible to finance a corporate rate reduction by increasing the tax rate on dividends and capital gains. Energy taxes or a financial transactions tax also could be used.

It is interesting that other countries have used increased income taxes on high-income individuals (as well as VATs) to fund corporate rate cuts. Indeed, the Debt Reduction Task Force recommended a 6.5 percent VAT. It is possible to ameliorate the fiscal crisis by allowing the Bush tax cuts to expire, even if that is postponed for a year or two until the economic recovery is secure. However, that will not provide revenues to reduce the corporate tax rate if revenue neutrality is the baseline. Some would question the likelihood of the enactment of a VAT if Congress is unable to take the easier political step of simply letting the existing tax cuts expire to address the fiscal situation. Nonetheless, it is difficult to see how the reduced corporate rate objective can be reached without it or another revenue source.

B. The Taxation of Foreign-Source Income

The appropriate way to tax business income earned outside the United States is a particular point of contention. In theory, there are two polar ways to tax offshore business income attributable to a U.S. enterprise. The first is to tax it all currently at the U.S. corporate rate (the worldwide system) with a tax credit for foreign taxes to eliminate double taxation. The second is to allow the source country to tax the income and permit the income to be returned to the United States without the payment of any U.S. tax (the territorial system). Under the former system, foreign taxes below the U.S. rate are irrelevant. In the latter, there is a U.S. tax advantage to having foreign income sourced to a low-tax jurisdiction. The current U.S. system is a hybrid of the two. Some passive income is taxed currently at the U.S. rate; the U.S. tax on most active business income is deferred until the income is repatriated to the United States.

The current system has been widely criticized on three grounds. The first is the lockout effect. Deferral creates an incentive for U.S. companies to keep active business earnings offshore, and it is estimated that unrepatriated foreign earnings amount to at least $1.4 trillion.[62] The second is the alleged base erosion that occurs as U.S.-based multinational companies transfer highly mobile, highly profitable

[57]*See* JCT tables 11-1 133 and 11-1 134, *supra* note 54.
[58]Ways and Means discussion draft summary, *supra* note 49.
[59]*Id.*
[60]JCT Table 11-1 134, *supra* note 54.
[61]JCT Table 11-1 133, *supra* note 54.

[62]Laura D'Andrea Tyson et al., ''The Benefits for the U.S. Economy of a Temporary Tax Reduction on the Repatriation of Foreign Subsidiary Earnings,'' *available at* http://newamerica.net/sites/newamerica.net/files/policydocs/brg_repatriation_tax_paper.pdf.

intangible assets to low-tax jurisdictions. The third is the complexity of the law.

U.S.-based multinational companies, pointing to the fact that most other developed countries have moved to a form of territorial taxation, advocate the adoption of a similar system in the United States. They cite an inability to compete effectively in the foreign jurisdictions as one reason for change. The other is to eliminate the lockout effect that the current system has for foreign earnings.

Others assert that the territorial system by definition provides an incentive for U.S. companies to locate active businesses outside the United States, thus promoting domestic job loss. Their answer is to move the United States closer to an effective worldwide system by eliminating or sharply reducing deferral. There is no lockout in a world in which all offshore income is subject to U.S. tax immediately. Moreover, they state that the appropriate way to view U.S. competitiveness is to examine how a particular policy affects the domestic standard of living. Thus, competitiveness arguments of the multinationals must be analyzed by measuring whether the benefit to the U.S. economy of a multinational's ability to compete in a foreign jurisdiction compensates for the loss of domestic economic activity that is encouraged by a territorial system.

The polar positions regarding the optimal international tax regime are reflected in the administration's proposals on one side and the Camp proposals on the other. The dichotomy is also seen in the contrasting proposals of the Bowles-Simpson and Domenici-Rivlin task forces.

C. Interactive Corporate and Individual Tax

The interaction of the corporate and individual taxes produces the thorniest problem in the business tax reform debate, and one that has yet to be fully recognized and explored. If a reduction in the corporate rate is financed by a reduction or elimination of business tax expenditures for all business income, the result is a tax *increase* for those who earn business income in passthrough form. That appears to be a political non-starter, but it is the only way to finance a corporate rate reduction to approximately 25 percent by simply reducing business tax preferences.

The inextricable connection between the corporate and individual tax leads to one further observation. If individual rates are higher than corporate rates, there is an incentive to use corporations to shelter income. That is not a new phenomenon. Many code provisions attempted to address that problem: the accumulated earnings tax, the personal holding company tax, and the provisions regarding collapsible corporations.

Virtually all tax commentators, regardless of their political persuasion, agree that the two-tier corporate tax is a ''bad'' tax. Because corporate income is taxed at the corporate level and then again when distributed, it encourages business activity to be undertaken in passthrough form. Because interest payments are deductible and dividend distributions are not, the tax encourages debt rather than equity financing. The commentators agree that the two-tier corporate tax should be eliminated and that business income should be taxed once — and only once — no matter the entity in which the income is earned. That is called integration, and there have been several studies proposing various ways to implement it.[63] Indeed, in 2003 the Bush administration proposed a form of integration: a dividend exclusion.[64] The proposal was opposed by many major corporations, perhaps because of a desire to control the expenditure of retained earnings. Dividend relief would encourage the distribution of those earnings.

Implementing an integration system is difficult under the best circumstances. The revenue lost by eliminating double tax would have to be offset. As a starting point, that should be done in a way that does not alter the distributional burden associated with the existing tax. In other words, if we knew who actually bears the economic burden of the corporate tax we could repeal it and explicitly increase the tax on those taxpayers. For example, if the burden of the corporate tax was borne by shareholders, dividend and capital gains could be increased, altering the distribution of the tax. On the other hand, if the burden is borne principally by labor, a VAT could come close to being distributionally neutral. The problem is that we do not know the answer to that question. Moreover, even if we did, replacing an implicit tax with an explicit one is a difficult political exercise — particularly without strong public support. As a result, it does not appear that the correct solution is on the horizon, leaving us with ad hoc solutions that will create many planning opportunities and enforcement difficulties.

D. Lack of Business Consensus

The business community is by no means united on tax reform objectives. While it is safe to assume that all corporate taxpayers would like to see the nominal corporate rate reduced, the requirement of

[63]Treasury, ''Report on Integration of the Individual and Corporate Tax Systems'' (Jan. 1992); Graetz and Alvin C. Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports*, Tax Analysts, 1998.

[64]Treasury, ''General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals,'' at 11 (Feb. 2003), *Doc 2003-3041*, *2003 TNT 23-11*.

revenue neutrality introduces discord. It is no secret that while the U.S. corporate rate is 35 percent, there are many corporations with effective tax rates well below that number.[65] For any company, the question will be whether business tax reform results in a higher effective tax rate. The answer will depend on how the corporate rate reduction is financed. There are four potential areas of conflict: the structure of international tax reform, domestic companies versus multinationals, capital-intensive domestic corporations versus other domestic corporations, and passthrough entities versus C corporations.

1. The structure of international tax reform. Multinational companies have two goals: a territorial tax system and tax relief for the repatriation of offshore earnings. Three questions emerge. Will the reform of the international tax system move in the direction of a territorial system or toward making the worldwide system more effective? If the former, what will the system look like? What will be the revenue consequences to the multinational sector of any changes?

The first question can't be answered now. The administration's proposals explicitly reject a territorial system. Moreover, they would extract revenue from the multinational sector to finance the corporate rate reduction. Most multinationals would find that that alternative would increase their effective tax rate.

Assuming a territorial system, there are a series of design issues that have serious consequences. The first is the scope of the income that will be subject to the system. Both the Camp and Enzi proposals (as well as all territorial systems adopted around the world) limit the system to income attributable to active business. One important threshold question then is the definition of active business. Conversely, the benefit of the system is not available for passive income. The questions here involve the definition of passive income and how that income will be taxed in the United States — for example, currently or when repatriated. Both Camp and Enzi would treat passive income as currently taxable in the United States. All other territorial systems have some form of base erosion protection, and the question is what the United States will adopt. The Camp and Enzi proposals contain several options, the consequences of which have to be analyzed by each multinational company.

The revenue consequences to the international sector obviously will depend on the structure of the system that is adopted. The administration's proposal will increase the tax burden of that sector. In contrast, both the Camp and Enzi proposals are intended to be revenue neutral to the international sector. That means that there will be winners and losers within that sector, which may well affect the enthusiasm with which particular companies embrace the proposal.

Apart from, but related to, the design of the territorial system is the question of how to treat the $1.4 trillion of currently unrepatriated corporate offshore earnings. Major U.S. multinationals formed the WIN America Campaign to lobby for a second tax holiday for those earnings. They seek a repeat of the 2004 Homeland Investment Act, under which unrepatriated earnings could be returned to the United States at a 5 percent tax rate. To date, their efforts have not been successful. The JCT has estimated that the provision would lose $78.7 billion over 10 years.[66] Camp and Geithner have both indicated that consideration of that proposal should be in the context of overall business tax reform.[67] Camp's proposal contains a mandatory 5 percent tax on all unrepatriated earnings, with an opportunity to defer payment over eight years with an interest charge. Enzi's bill contains a similar provision. However, his provision is elective, with an applicable tax rate on the repatriated earnings of 10.5 percent. It is unlikely that the issue will be addressed independently of overall business tax reform.

2. Domestic versus multinational companies. Many domestic corporations, particularly in the retail and service industries, have federal effective tax rates that are at or near the statutory 35 percent rate. Many multinationals, particularly those in the pharmaceutical and high-tech industries, have effective rates in the mid- to low 20s.[68] Obviously, revenue-neutral reform will affect those sectors differently, and the extent to which that will occur depends on how the rate reduction will be financed. For example, repeal of the section 199 deduction or failure to extend the research credit will not affect service or retail companies. Those sectors will be in favor of any rate reduction financed by those sources. Multinational companies will want to avoid having their preferences reduced to pay for domestic rate reduction. As a general proposition, a

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[65]*See* the framework, *supra* note 38, at 5.

[66]JCT, Letter to Rep. Lloyd Doggett, D-Texas, Apr. 15, 2011, *Doc 2011-10226*, *2011 TNT 55-30*.

[67]*See, e.g.*, Ferguson et al., "Geithner Says No Corporate Tax Reform, Repatriation in FY 2012 Budget," BNA (Feb. 10, 2011); Blake Rubin, "Cash Hoard Grows by Untaxed Overseas Profits," Bloomberg, Mar. 2, 2012.

[68]*See, e.g.*, testimony of Martin A. Sullivan before the Ways and Means Committee, Jan. 20, 2011, *Doc 2011-1281*, *2011 TNT 14-44*.

revenue-neutral reduction of the corporate rate to 28 percent will benefit domestic entities and harm many multinationals.

3. Domestic manufacturers versus other domestic corporations. Again the question will be which preferences finance the rate reduction and whether benefit of the rate reduction exceeds the tax cost of the preference repeal. For example, manufacturers will focus on the fate of the section 199 manufacturing deduction. Capital-intensive industries will focus on the implication of potential alterations of the capital cost recovery system. Similarly, research-heavy companies will pay attention to the fate of the R&E credit. Those with LIFO inventory will worry about the consequences of repeal. Again, the preferences selected to finance the rate reduction will affect companies differently.

4. Passthrough entities versus C corporations. Perhaps the most difficult issue is to ensure that the changes do not unduly affect the tax burden of the passthrough sector. As previously discussed, that is a serious structural, administrative, and political issue, which has no good practical solution short of integration. The existence of the problem has the potential to pit the owners of passthrough entities against the corporate community.

E. Wealth Transfer Tax

One of the most baffling aspects of the reform debate has to do with the wealth transfer taxes. At a $3.5 million exemption level, the tax will affect less than 0.3 percent of individuals dying each year.[69] However, the revenue associated with the tax is not insignificant. At that level and with a maximum rate of 45 percent, the tax is estimated to raise roughly $16 billion in 2013, rising to $29 billion in 2019.[70]

Apart from revenue, there is an important policy role for a tax on wealth transfers in our tax system. Capital income is relatively lightly taxed by the income tax and the appreciation in assets held at death is forgiven by the rules that give an heir a basis equal to date of death value. The wealth transfer tax acts as a rough remedy to ensure that some tax is paid by those owning appreciated property.[71] There would be no tax policy need for the tax if death were treated as an income tax realization event. Sensible rules can be devised to deal with illiquid assets.

VI. The Practical Constraints

There are two principal practical constraints associated with reform legislation: legislative procedural rules and the lack of executive leadership.

A. Procedural Rules

Congressional consideration of tax legislation is governed by several procedural rules that have the potential to materially affect the outcome. The most obvious is the Senate filibuster, which can be overcome only by 60 votes to invoke cloture. Also, special rules created by the Budget Enforcement Act apply to tax legislation in both chambers.[72]

The procedural impediments in the Senate can be overcome using reconciliation. If Congress adopts a budget resolution that contains reconciliation instructions, the legislation that implements that budget resolution is procedurally protected. The implementing legislation is subject to a time limit on debate and consequently cannot be filibustered. Amendments must be germane. And most significantly, if the reconciliation instructions authorize revenue-losing legislation, the legislation is not subject to a Budget Act point of order as long as the authorized revenue loss is not exceeded.

For the current Congress, the importance of those procedural rules cannot be overemphasized. First, Congress will not pass a budget resolution this session. While not a law (that is, the president does not sign it), the resolution must be agreed on by both chambers, and that simply will not happen. The upshot is that the normal procedural rules apply. Because neither party has 60 votes in the Senate, it is unlikely that any significant changes can be adopted. Second, the November election outcome will affect lame-duck consideration of legislation. For example, if either party secures a majority in both chambers, a budget resolution in the next Congress becomes more possible. The content of that budget resolution would, of course, depend on which party is in control. But the agenda of that party could conceivably pass Congress using reconciliation. The ultimate enactment of that legislation would depend on who is president. If the president is of a different party, the possibility of a veto would always remain. Alternatively, the election could result in each chamber controlled by a different party, in which case agreement in the next Congress would remain conjectural. None of those post-election scenarios suggests that a lame-duck session will do any more than attempt to resolve the

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[69] Tax Policy Center, "Estate Tax Returns and Liability Under Current Law and Various Reform Proposals, 2009-2019," T09-0431 (Oct. 30, 2009), *Doc 2009-24094*, *2009 TNT 210-30*.

[70] Roberton Williams, "Where, Oh Where, Has the Estate Tax Gone?" *Tax Notes*, Dec. 21, 2009, p. 1353.

[71] *See* Harry L. Gutman, "Reforming Federal Wealth Transfer Taxes After ERTA," 69 *U. Va. L. Rev.* 1183, 1187-1197 (1983).

[72] Under the Budget Act a point of order lies against tax legislation that is not revenue neutral when measured in specific time periods. It requires 60 votes to waive the point of order in the Senate.

impending expiration of the Bush tax cuts or the tax provisions that expired at the end of 2011.

The revenue neutrality threshold and the revenue-estimating process are also a source of confusion and contention. The JCT provides the revenue estimates that bind Congress. An estimate is determined by assessing the revenue consequences of any change in the tax law in comparison to current law. The method involves a static estimate of the revenue change as well as an adjustment to take into account anticipated taxpayer behavior.[73] The macroeconomic effects on the economy and the potential revenue consequences of those effects are not taken into account. The latter is often referred to as dynamic revenue scoring.

Dynamic revenue scoring has been a hot debating point for many years.[74] While most tax law changes are too insignificant to affect the macroeconomy, major changes might not be. For example, some assert that the positive economic effects of a major income tax rate reduction will produce economic growth (and consequent tax revenue) sufficient to offset the static tax loss of the rate reduction. That assertion is nonsense. While tax changes can stimulate the economy, the most aggressive estimates have found that no more than a fraction of the tax loss will be recaptured through growth over the long term.[75]

There is no question that an estimate would be more accurate if the macroeconomic effects were taken into account. The principal reason that is not done is a lack of agreement on the method to apply to yield the precise numbers that are required by the Budget Act.[76] However, the JCT occasionally discusses the anticipated macroeconomic effect of tax law changes by indicating a range of possible outcomes.[77]

B. Executive Leadership

Many have commented that the goal of tax reform should be to replicate the results of the Tax Reform Act of 1986, in which the individual and corporate tax rates were reduced, there was no rate difference between capital and wage income, and the corporate tax base was broadened. That goal is laudable, but this is not 1986 — it is more like 1984.

TRA 1986 was preceded by two comprehensive Treasury studies.[78] Extensive hearings were held. The effort was led by President Reagan; Sens. Dole, Packwood, and Bradley; and Ways and Means Committee Chair Dan Rostenkowski.

Except for a series of hearings, nothing comparable has happened today. There have been no detailed Treasury studies or proposals. The president has not made any significant commitment to tax reform. Congress is fractured. There is no easy available revenue source.

History informs that major tax changes cannot occur without executive branch leadership. Even then the task is difficult; without it, the effort is unlikely to get off the ground.

C. Timing of Congressional Consideration

Legislation to avoid the fiscal cliff is not likely to be enacted before the election — although there will be plenty of posturing and empty threats. And all the oxygen of the lame-duck session will be spent avoiding going over that cliff. That is when Congress will have to address the expiration of the Bush tax cuts, the other expiring provisions, the sequestration mandated by the Budget Control Act, and possibly a debt ceiling increase. There will not be time to address the business tax.

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[73]JCT, "Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation," JCX-1-05 (Feb. 2, 2005), *Doc 2005-2081*, *2005 TNT 22-9*.

[74]*See generally* Buckley, "Dynamic Scoring: Will S&P Have Company?" *Tax Notes*, Feb. 27, 2012, p. 1141, *Doc 2012-1844*, or *2012 TNT 39-7*.

[75]*See, e.g.*, Greg Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back of the Envelope Guide," National Bureau of Economic Research Working Paper 11000 (Dec. 2004).

[76]*See* JCT, "Joint Committee on Taxation Tax Modeling Project and 1997 Symposium Papers," JCS-21-97 (Nov. 20, 1997), *Doc 97-31765*, *97 TNT 225-13*.

[77]*See* JCT, "Overview of the Work of the Staff of the Joint Committee on Taxation to Model the Macroeconomic Effects of Proposed Tax Legislation to Comply With House Rule XIII.3(h)(2)," JCX-105-03 (Dec. 22, 2003), *Doc 2003-26926*, *2003 TNT 246-8*.

[78]Treasury, "Tax Reform for Fairness, Simplicity and Economic Growth" (Nov. 1984); Treasury, "The President's Tax Proposals to the Congress Tax Fairness, Growth and Simplicity" (May 1985).