Finance Committee mulls business tax reform options

Lawmakers and witnesses at an April 26 Senate Finance Committee hearing on business tax reform generally agreed that the US corporate tax rate is uncompetitive and needs to be reduced, that the US needs to move toward a territorial system for taxing foreign-source income of domestic multinationals, and that the tax rules – particularly as they apply to small businesses – need to be simplified; but they did not appear to reach consensus on how to make that happen.

The hearing addressed a report released last July by the Finance Committee's bipartisan working group on business tax reform. Although the report made no specific recommendations for business tax reform, it highlighted two “threshold issues” that the working group viewed as key to the success of any reform plan – lowering the corporate tax rate and treating passthrough businesses equitably – and offered a lengthy discussion of the challenges inherent in achieving these goals in a revenue neutral way.


The panel also discussed issues around an as-yet unreleased proposal on corporate integration from Finance Committee Chairman Orrin Hatch, R-Utah, and a just-released discussion draft on simplifying the current-law depreciation regime from ranking Democrat Ron Wyden of Oregon.

Corporate integration

In his opening remarks, Hatch, who hopes to release his discussion draft proposal on corporate integration in June, noted the disparate treatment of businesses established as C corporations – which are taxed once at the entity level and once at the shareholder level – versus passthrough entities like partnerships and S corporations, which are only taxed at the owner level. Hatch argued that the distortion caused by double taxation is harmful to businesses in the US and alleviating it will make the US a more attractive place to invest and do business. A corporate integration plan, depending on its design, “could have the effect of reducing the effective corporate tax rate and help address some of the strong incentives we are seeing today for companies to relocate their headquarters outside of the United States,” he said.

Hatch asked witnesses to comment on how they think integration will help to solve some of the issues facing taxpayers currently.

James Hines, Jr., professor of law at the University of Michigan, said that a “thoughtful” corporate integration plan could address some competitiveness issues; but he added that the US will never be “truly competitive” with other capital exporting countries unless it switches to a territorial system.

Eric Toder of the Urban-Brookings Tax Policy Center added that an integration plan designed to transfer the tax burden from the entity to the shareholders could reduce income shifting, as individuals are less likely to relocate for tax reasons. However, Toder warned of issues that
would still need to be addressed. For example, high taxes on retained earnings could increase the cost of capital for corporations who choose not to pay dividends. Also, he noted that roughly 75 percent of dividends are paid to tax-exempt recipients (such as foreign shareholders and pension funds), so removing the entity-level tax could lead to a large revenue loss.

**Simplifying depreciation**

Wyden remarked in his opening statement that he developed his Cost Recovery Reform and Simplification Act (released in draft form the morning of the hearing) to reduce complexity for US small businesses, “who don’t have a team of accountants and the luxury of time to plan investments around taxes.” According to Wyden, the proposal would pull the depreciation rules out of the “era of fax machines and VCRs” and into the twenty-first century economy by consolidating the more than 100 current-law depreciation schedules into six “pools” that would be used to recover the cost of capital assets with similar lives. (See separate coverage in this issue for additional details on the discussion draft.)

Wyden asked witnesses whether they felt his depreciation proposal would be helpful in reducing complexity for small businesses.

Sanford E. Zinman of Sanford E. Zinman, CPA, PC, in Tarrytown, N.Y., said that he believed simplification of business depreciation deductions for small businesses is necessary and would be welcomed by business owners.

Gayle Goschie of Goschie Farms, Inc., in Silverton, Ore., likewise said such a proposal would remove inequities currently in the tax code and put businesses on a level playing field.

**Aggressive rate cuts v. Faster depreciation:** Wyden’s discussion draft is designed to be revenue-neutral and therefore does not attempt to change, on the whole, how quickly businesses are allowed to write off investments. However, Sen. John Thune, R-S.D., noted that there is a “tension” between tax reform plans that aggressively seek to cut the corporate rate but lengthen depreciation schedules as a tradeoff (similar to the tax reform plan proposed by in 2014 by then-House Ways and Means Committee Chairman Dave Camp, R-Mich.) and proposals that cut rates less aggressively but allow businesses to write off expenses more quickly. Thune, who was one of the co-chairs of the Finance Committee’s business tax reform working group, asked witnesses for their thoughts on which type of plan would be more effective at promoting economic growth.

Hines answered that faster capital cost recovery has a larger effect dollar for dollar on increasing investment but that a lower statutory corporate tax rate would affect more aspects of the system, such as the preference for low-tax foreign income. However, he cautioned that paying for a lower rate with longer depreciation would lead to less investment.

Toder agreed, but he cautioned that moving to full expensing could lead to gaming of the system unless Congress also adopts restrictions on interest deductions.
**Parity for passthroughs**

Several Finance Committee members expressed concern that because so many American businesses – more than 40 percent by revenue – are organized as passthrough entities, a reduction in the corporate tax rate without a corresponding cut in the individual tax rates would be unfair.

Thune cited three alternative approaches to addressing passthroughs: a business equivalency rate (that is, imposing the same tax rate on corporations and passthrough entities), a targeted tax benefit approach involving higher expensing limits and/or expanded use of cash accounting, and a flowthrough business deduction which would give passthroughs a deduction on business income to lower their effective rate. He then asked witnesses to weigh in on which approach be most effective if Congress is unable to tackle individual and corporate rates simultaneously.

Toder and Hines both agreed that higher expensing limits would allow passthroughs to remain competitive without worrying about rate differentials.

Toder noted that rate equivalency could create a problem with respect to closely held companies, where “it becomes hard to distinguish between a small business and an employee,” which in turn can “lead to gaming” between the tax rate on compensation and the tax rate on business profits.

Hines added that deductions and credits for small businesses are also helpful because they are more responsive to tax incentives.

(On the other side of the Capitol, House Ways and Means Committee member Vern Buchanan, R-Fla., released a discussion draft proposal on April 27 aimed at ensuring that the rate paid by passthrough entities on business income would not exceed the corporate tax rate. See separate coverage in this issue for details.)

**Business-only/International-only reform?**

In the absence of comprehensive tax reform, which many members of the committee see as unlikely in the near term, several taxwriters asked about the advisability of pursuing piecemeal reform that would address only the business side of the tax code or, alternatively, only the international tax rules.

**Business-only:** In response to a question from Sen. Dan Coats, R-Ind., Toder said that a business-only approach was not viable and that reform needed to address the owners of the business as much as the business itself.

Hines replied that there are improvements that can be made in a business-only reform, but added that larger problems cannot be addressed with reform that narrow.

Zinman cautioned that using a “band-aid approach” to tax reform would ultimately lead to added complexity in the code.
International-only: Sens. Tom Carper, D-Del., Rob Portman, R-Ohio, and Charles Schumer, D-N.Y., asked whether international-only reform would make US businesses more competitive and reduce the number of inversions and foreign acquisitions of US companies. (Last year, Portman and Schumer engaged in talks with then-House Ways and Means Committee Chairman Paul Ryan, R-Wis., on a proposal to move international-only tax reform as part of a larger infrastructure spending bill, with revenue from a deemed repatriation tax allocated to increased highway spending. The talks eventually collapsed because of disagreements over highway funding levels.)

Toder noted that there seems to be “at least a conceptual agreement” in Congress on the need for a one-time tax on unrepatriated income and a minimum tax on foreign profits of US multinationals going forward. Enacting those changes “would make our current international system a little more efficient than it is,” he said. But he also cautioned that such an approach would not solve “the fundamental problem of competitiveness, inversions, and the shifting of income overseas.”

Hines replied that Congress should pursue international-only reform if the alternative was to do nothing, but emphasized that broader action was preferable.

In response to a question from Sen. Dean Heller, R-Nev., about what can be done to make the US tax system more competitive and prevent further inversions, Hines stated that switching to a territorial system would be a good start. Toder argued that in addition to adopting territoriality, Congress should also pursue legislation to address earnings stripping.

Patent boxes

Sen. Tim Scott, R-S.C., who noted that his state is home to a number of companies in the life sciences sector, asked several questions about the best way to allocate benefits under a patent box regime to keep research-intensive companies – and the jobs they create – in the US.

Hines argued that even if Congress does not adopt a patent box, it needs to do something to keep highly mobile intellectual property (IP) income onshore – and attract IP income that would otherwise be located elsewhere. But he cautioned that the regime would need to be carefully crafted, since making it too inclusive could lead to base erosion.

Toder disagreed and expressed concern a patent box could simply become a new tax planning vehicle without leading to any increased innovation. Instead, he suggested enhancing the current-law research and development credits to encourage innovation in the US.

Joint Committee in Taxation (JCT) Chief of Staff Thomas Barthold cautioned in his prepared testimony that patent box regimes create unique policy and administrative issues, such as what categories of intellectual property would be eligible for patent box treatment and whether a patent box should include the nexus requirements that have been part of comparable European systems. Barthold also noted that the tax code already includes incentives for promoting the creation of IP domestically – for example, the US allows full expensing of research costs and last year’s extenders deal made permanent the section 41 research and experimentation credits.
Consumption tax

While many remarked that the US corporate tax rate is uncompetitive and needs to be lowered, Barthold warned that making a more competitive tax structure will be costly. By JCT’s estimates, a 1 percent reduction in the corporate tax rate equates to $100 billion in lost revenue over the 10-year budget window.

Sen. Ben Cardin of Maryland, the Democratic co-chair of the committee’s business tax reform working group, suggested that the cost of a significant reduction in the corporate income tax rate could be offset in part through the imposition of a 10 percent national value-added tax (VAT) using the credit-invoice system. Cardin, who introduced a credit-invoice VAT proposal in 2014, asked the witnesses for their take on his proposal and whether or not it would boost competitiveness.

Hines replied that such a proposal would reduce inefficiencies, stimulate investment, and make the tax system more competitive. Toder agreed, although he noted that there would be challenges involved in implementing a VAT, especially if it included exemptions.

— Jacob Puhl
Tax Policy Group
Deloitte Tax LLP