Comprehensive Tax Reform For 2015 and Beyond

Reviewed by Curtis Beaulieu

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In this article, Beaulieu reviews *Comprehensive Tax Reform for 2015 and Beyond* by Finance Committee Chair Orrin G. Hatch and his staff.

On December 11, 2014, Senate Finance Committee Chair Orrin G. Hatch, R-Utah, and his staff unveiled a 342-page primer on the history of taxes in the United States. The book chronicles the development of the U.S. tax system over the past 100 years, paying particular attention to the increasing complexity that has evolved since the Tax Reform Act of 1986 — on both the individual and corporate sides. It includes Joint Committee on Taxation estimates, Congressional Budget Office projections, committee hearing testimonies, think tank analyses, and proposals from former taxwriting committee chairs. The text does not offer a comprehensive plan on how to reform the tax code, but it does suggest ways Congress could address some problems with the code.

To condense the entire 70,000-page tax code (including its history and analytical data) into fewer pages than an Ikea catalog is quite a challenge. This article breaks it down even more and analyzes hundreds of pages, which analyzed thousands of pages. Read on for five specific items to note in Hatch's book.

In *Comprehensive Tax Reform for 2015 and Beyond*, Hatch and the Republican staff of the Finance Committee thoroughly compile a vast amount of data and present it plainly. The work is both necessary and encouraging to get the debate on tax reform moving.

The book debunks many myths about our current tax system: The tax code isn't very progressive? It is — except for the top one-tenth of 1 percent.[1] The richest do not pay their fair share? They do.[2] The corporate tax doesn't affect labor? It does.[3] Most Americans pay taxes? They don't.[4] In fact, nearly half of all households do not pay or, rather, do not owe a federal income tax, and an estimated 23 million households actually make money off our tax system.[5] Those conclusions are backed by data and estimates from the JCT, the apolitical congressional surveyor of our tax system.

Energy companies in particular should pay close attention to Hatch's book. While the book does not offer specific proposals, it forms the parameters for a plan that could have major ramifications for how entities are created in the future. As an example, the book mentions master limited partnerships currently in the tax code as a way to achieve a single level of taxation. It is unclear whether Hatch proposes to expand this concept or repeal it in conjunction with creating alternative means of achieving a single level of taxation.

As for specific tax expenditures that benefit the energy industry, the book notes that "the top ten corporate tax expenditures make up 90 percent of the total dollars of tax expenditures directed to corporations."[6] It also posits "that if all corporate tax expenditures were repealed and utilizing only the portion of revenue attributable to C corporations, the top corporate tax rate could be lowered to 25 percent in a revenue neutral manner."[7]

In June 2013, Hatch, former Finance Committee ranking minority member, and Max Baucus, former committee chair, sent to their fellow senators a letter that called for input on tax reform.[8] The letter assumes a "blank slate" by eliminating all tax expenditures and then asks senators to offer which tax expenditures to include while showing how those tax expenditures promote economic growth, fairness, and other policy objectives. It then notes

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[1]Hatch and Republican staff, *Comprehensive Tax Reform for 2015 and Beyond* 3 (2014).
[2]Hatch, *supra* note 1.
[3]*Id*.
[4]*Id*. at 2.
[5]*Id*. at 3.
[6]*Id*. at 177.
[7]*Id*.
[8]Baucus and Hatch, "Next Steps on Tax Reform" (June 27, 2013).

that "every $200 billion of corporate tax expenditures that are added back to the blank slate would, on average, raise the top corporate income tax rate by 1.5 percentage points."[9] Corporate tax expenditures amounted to roughly $888 billion over a five-year period from 2014 to 2018.[10]

While revenue forgone would not necessarily equal revenue raised from eliminating certain tax expenditures, it is safe to assume that almost all the corporate tax expenditures will be eliminated or substantially reduced *if* Hatch is pursuing a corporate tax rate of 25 percent or lower. That does not even take into consideration Hatch's call for eliminating the double taxation of business income.[11]

So if an energy company benefits from the wind production tax credit, which costs $13 billion over five years, or the expensing of intangible drilling costs, which costs $5 billion over five years, or uses percentage depletion, which costs $7.3 billion over five years, the company should plan for these tax expenditures to be eliminated or substantially reduced to lower rates.[12]

Further, if Hatch proposes a plan that includes corporate integration (as he has suggested), then energy companies that benefit from a single level of taxation through their formation as publicly traded partnerships or master limited partnerships should be concerned that being taxed as a passthrough entity could cause them to lose their advantage in luring capital investment. If the plan does not include corporate integration, look for this tax expenditure, which costs $5.8 billion over five years, to be eliminated or reduced.[13]

Below are five things to pay particular attention to in Hatch's *Comprehensive Tax Reform for 2015 and Beyond*:

1. Principles of tax reform. While the book does not propose a plan with the specificity of recent tax reform proposals, it lists seven guiding principles, three of which President Reagan used for the 1986 act, that should guide tax reform this go-round. The document calls for engineering a tax system that includes efficiency and economic growth, fairness, simplicity, revenue neutrality, permanence, competitiveness, and incentives for savings and investment.[14] Finance Committee Republicans unveiled these principles in October 2011, and they continue to guide the work of Hatch, his staff, and most Republicans sitting on the committee.[15]

2. A consumption tax? The book discusses some of the reasons why the 1986 act was in many ways successful. For example, to lower the individual rate, the 1986 act had to increase the corporate tax.[16] That strategy would be virtually impossible today, according to the writers, because the U.S. corporate tax is already the highest corporate tax rate among the OECD countries, and part of what is driving tax reform is the goal of making the U.S. corporate tax more competitive with those of other countries.[17] Hatch also uses the book to reiterate his long-held position that tax reform should not raise revenue.

The question becomes: If we cannot raise the corporate tax rate or raise additional revenue, and simply broadening the base and lowering the rates will be extremely difficult (as we learned from the bill proposed by Dave Camp), where is the revenue going to come from to lower the rates?

The answer to that question is found in several places throughout the book.

First, the writers allude to another component that should be considered outside the traditional lowering the rates and broadening the base. The introduction states that "evidence suggests that a broad-based consumption tax system would lead to greater efficiency and economic growth."[18]

Then the book suggests that we should rely more on a consumption-based tax system to promote savings and investment.[19] It explains that there is a double tax on savings and capital gains.[20] Released one day after Finance Committee member Benjamin L. Cardin, D-Md., introduced a bill calling for a VAT, this text states plainly that "a VAT is a bad idea," but it does not rule out another consumption tax — an individual consumption tax.[21]

Under an individual consumption tax, consumption is determined by taking an individual's wages (that is, excluding income from investments), subtracting any amount saved, and then taxing the remainder — which is presumed to be consumption. While the writers do not dismiss other pro-

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[9] *Id*. at 2.
[10] Hatch, *supra* note 1, at 176.
[11] *Id*. at 124.
[12] JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017," JCS-1-13 (Feb. 1, 2013).
[13] *Id*.
[14] Hatch, *supra* note 1, at 77.
[15] Hatch, Remarks at the Reagan Ranch, "Constitutional Conservatism and the Senate GOP Agenda" (Oct. 8, 2014).
[16] Hatch, *supra* note 1, at 6.
[17] *Id*. at 4, 240.
[18] *Id*. at 3.
[19] *Id*. at 41.
[20] *Id*. at 43.
[21] *Id*. at 55.

posed forms of consumption taxes including the USA Tax,[22] the Fair Tax,[23] the Flat Tax,[24] or Graetz plan,[25] the book offers the most detail on the advantages of the individual consumption tax.[26]

3. Broadening the base and lowering the rates are easier said than done. There is a lot of tax talk about "broadening the base" and "lowering the rates." The latter is mostly self-explanatory; the only issue is how low the rates should go. That question is mostly determined by how widely the base is broadened. Broadening the base does not necessarily mean getting more taxpayers to pay taxes. Rather, it means eliminating tax expenditures across the board, so that there is a larger base of income that is taxed.

The book analyzes several outcomes based on various tax plans that broaden the base and lower rates, including the Camp plan.[27] For each analysis, different sets of assumptions and models are put in place to predict economic effects. In all cases, the writers found that the economic output measured by the GDP would be positive both in the near and long terms.[28] However, to get an increase in GDP, the models require eliminating or scaling back some very popular tax expenditures, including tax incentives for health, education, retirement, charitable contributions, and purchasing homes.[29] These changes would not come without consequence. Eliminating these tax expenditures, as the book notes, would have a greater effect on middle- and lower-income wage earners.[30] This reality makes cutting these tax expenditures politically unpalatable, especially in a presidential election year and a year in which nearly half of the members of the Finance Committee are up for reelection.

On the business side, the book calls for eliminating almost all corporate tax expenditures to lower the effective corporate tax rate.[31] The 10 largest tax expenditures include the deferral of active income of controlled foreign corporations, the deduction for domestic production activities, the deferral of gain for like-kind exchanges, and the expensing of research and development.[32] The threat to those top 10 corporate tax expenditures is even worse when you consider that they make up 90 percent of the total value of all corporate tax expenditures.[33]

4. Corporate integration. The book spends several pages explaining various methods of achieving better corporate integration and thereby reducing or eliminating the distortions between the individual and corporate tax systems.[34] The purpose of corporate integration is to eliminate the double taxation of income. The writers point to existing examples of corporate integration in the current tax system such as master limited partnerships, real estate investment trusts, or S corporations. They suggest that this model can be expanded to other business income now subject to the corporate tax by allowing a dividends paid deduction, a comprehensive business tax, or a shareholder allocation method, among other options.[35] What the document does not address is the question about revenue decreases: If revenue decreases from corporate integration, how will the decrease in revenue from the lack of the current double taxation be regained to lower the effective tax rates while maintaining revenue neutrality?

5. International tax. It is no surprise that Hatch calls for adopting a territorial type of tax system. He has been advocating moving toward this type of system for more than a decade. While the new book does not specifically lay out how to accomplish a territorial tax system, it does offer some guiding principles: (1) no continuing lockout for both current foreign earnings trapped overseas and future earnings, (2) no windfall to U.S. multinationals, and (3) no windfall to the U.S. government.[36] The book further highlights that, even if we move to a territorial tax system, measures to combat anti-base-erosion would still be necessary.[37] Those measures may include strengthening current anti-base-erosion measures, such as section 163(j), to address earnings stripping or renegotiating tax treaties — a strategy Treasury is considering to prevent inversions.

The book does not commit to any proposal but noticeably favors some by exploring them in greater detail. Building on some of the past stated principles of tax reform expressed by Hatch and other Republican members of the Finance Committee, the book stops short of designating the means to achieve those principles. Still, the book provides an

[22]"USA (Unlimited Savings Allowance) Tax Act of 1995," S. 722, 104th Cong., 1st Sess. (1995).

[23]"Fair Tax Act of 1999," H.R. 2525, 106th Cong., 1st Sess. (1999).

[24]Robert Hall and Alvin Rabushka, *The Flat Tax* (2007).

[25]Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (2007).

[26]*Id*. at 58-59.

[27]*Id*. at 90.

[28]*Id*. at 91.

[29]*Id*. at 90.

[30]*Id*. at 74.

[31]*Id*. at 177.

[32]*Id*.

[33]*Id*.

[34]*Id*. at 185.

[35]*Id*. at 161-163.

[36]*Id*. at 524.

[37]*Id*. at 253.

insightful framework for companies who are considering the effects of tax reform. Expect more details about a specific plan to be released as long as Hatch can keep the discussion alive.