BUSINESS INVESTMENT AND INNOVATION

Senate Finance Committee Staff Tax Reform Options for Discussion

April 11, 2013

This document is the second in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or the Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

Under current law, businesses determine their taxable income using a complex set of rules that, in many cases, differs from the rules they use to calculate their financial or "book" income. Financial income is the measure of income that businesses are required to compute each year for financial accounting purposes, and it follows the generally accepted accounting principles (GAAP) or some other form of financial accounting. Taxable income is the measure of income they must compute in paying their taxes.

These differences between taxable income and financial income reflect the different objectives of tax policy and the accounting rules. Financial accounting rules are designed to paint a picture of a business's absolute and relative financial performance. The tax rules should be designed to equitably and efficiently collect revenue. In addition, while some disagree with this practice, the tax rules are often used to promote other policy objectives, such as incentivizing certain economic behaviors that policymakers consider socially valuable.

As a consequence of these special accounting rules and incentives embedded in the tax code, businesses spend large amounts of time and resources every year trying to calculate their tax liability. Tax reform provides an opportunity to simplify these provisions and, if members of Congress decide tax incentives are desirable, make those tax incentives more effective. This paper discusses options for reforming the rules regarding business investment, tax accounting, and innovation, with special attention to smaller businesses. Following are some potential broad principles for reform in this area:

- Simplify the law in order to reduce the cost to businesses of complying with the tax code
- Make the tax code more neutral by eliminating or reducing differences in effective tax rates across industries and business activities
- If policy makers choose to include incentives in a reformed tax code, ensure that those incentives are effective and efficient
- Provide businesses with greater certainty

Some specific concerns about the taxation of business investment and innovation include the following:

- **Overall complexity:** Current law provides numerous tax expenditures for businesses. Tax expenditures are provisions in the tax code that deviate from a "normal" income tax. While the definition of a tax expenditure is inherently subjective, the Treasury Department and the Joint Committee on Taxation (JCT) have both published different lists of what they define as tax expenditures since 1968 and 1972, respectively. According to JCT, there are over 140 business tax expenditures in the tax code today. Among businesses with 20 employees or less, tax compliance costs $1,584 per employee, according to a 2011 Small Business Administration study. (JCS-1-13; Small Business Association, Frequently Asked Questions)

- **Large differences in effective tax rates by industry:** Tax expenditures create large disparities in the tax treatment of different types of business investment, which may distort investment choices. According to the Treasury Department, the average federal corporate tax rate varies from a low of 14% for utilities to 31% for construction. Other studies have shown wide disparities in the taxation of different asset types. (President's Framework for Business Tax Reform, February 2012; CRS, Corporate Tax Reform: Issues for Congress, Dec. 26, 2012)

- **Uncertainty created by temporary provisions**: The tax code has been amended more than 15,000 times since 1986 (President's Economic Recovery Advisory Board's Report on Tax Reform Options, August 2010). Over 60 tax provisions expire in 2013. The temporary nature of expiring tax provisions makes it difficult for business taxpayers to

plan. For example, the research and development (R&D) credit has been extended at least 15 times since 1981. The Section 179 limitations on the amount of property that can be immediately expensed, which were increased retroactively at the beginning of this year, have changed at least 7 times since 2002.

- **Increasing international competition in innovation**: The U.S. faces increasing competition in maintaining its R&D base. Some are also concerned about increasing international competition in specific industries, such as manufacturing. Others believe the tax code should not favor one business sector over another. Most of our major trading partners are enhancing the benefits they offer for R&D to entice companies to locate R&D centers in their countries, with the associated high paying jobs. For example, China, India, Brazil, the UK, Ireland, Singapore, Australia, Russia, and France have recently increased their tax incentives for R&D. According to the Organisation for Economic Cooperation and Development (OECD), in 2008, U.S. R&D tax incentives ranked 24th out of 38 developed countries surveyed. (OECD Science, Technology, and Industry Scoreboard 2009) On the other hand, the OECD found that for 2009, the United States was second in total government subsidies for R&D as a percentage of GDP, looking at both direct subsidies and tax incentives. (OECD Science, Technology, and Industry Scoreboard 2011)

- **Limited business effect of tax incentives that defer tax liability**: Some tax incentives allow businesses to pay tax later than it would otherwise be due. Such timing changes do not affect the nominal amount of taxes due, although they can be very valuable due to the time value of money. For example, accelerating depreciation deductions means that a business pays less tax in the years immediately following the purchase of an asset, but pays correspondingly more tax later in the useful life of the asset. Many publicly-traded corporations and certain private businesses often plan with a focus on financial income. In general, changes in the timing of paying a tax do not impact financial income and, as a result, may not significantly affect business behavior. Therefore, to incentivize business behavior, it may be more effective to provide tax incentives that are not timing-based, but instead are, for example, rate reductions or credits.

REFORM OPTIONS

I. SMALLER BUSINESSES

There is no agreed-upon definition of what constitutes a small business. For example, JCT has identified at least 42 different definitions of a small business or small employer in the tax code.

Nevertheless, there are several provisions of current law that could be targeted for reform as they apply to small businesses (although some think the definition of a small business in these rules is overinclusive or underinclusive):

- **Section 179 expensing**: Under Section 179, businesses can immediately expense certain property, such as equipment or machinery, instead of depreciating the property. The maximum amount that can be expensed is $500,000 for 2013. This amount is phased out once qualifying property exceeds $2,000,000. In 2014, the maximum amount will become $25,000, phasing out at $200,000.

- **Cash method of accounting:** Under current law, generally certain businesses with average annual gross receipts under $5 million can report their income and expenses (other than inventory) using a cash method rather than an accrual method. The same is true of certain farming businesses and personal service businesses. Taxpayers using a cash method generally report income when they receive it and deduct expenses when paid. Taxpayers using an accrual method generally report income when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. Accrual method taxpayers deduct expenses when all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has taken place.

- **Inventory accounting:** If the production, purchase or sale of goods is an income-producing factor for a business, then the business is required to use inventory accounting for the goods. The rules for deducting the costs of inventory vary depending on whether the costs are direct or indirect. For direct costs, businesses that earn income from inventory are required to "capitalize" (meaning not immediately deduct) the costs of inventory that they produce or purchase, and then recover the costs when the goods are sold. In addition, with very few exceptions, businesses with inventory are required to use the accrual method of accounting for inventory. For indirect costs of inventory, businesses that produce their own inventory are typically subject to an additional set of rules—the so-called uniform capitalization ("uni-cap") rules—which require them to capitalize indirect costs associated with producing inventory. In contrast, businesses that purchase their inventory for resale are not subject to the uni-cap rules unless they have average annual gross receipts exceeding $10 million.

- **Research and development credits:** As an incentive to encourage innovation, businesses can claim a credit for incremental spending on labor and supplies used for research. This credit is non-refundable. This means that businesses are only entitled to

claim the credit to the extent that they have sufficient income tax liability to offset. If they do not, such credits may be carried back one year and carried forward 20 years.

- **Start-up and organizational expenditures**: The first $5,000 of start-up and organizational expenditures incurred in the context of starting a new business may generally be expensed, subject to a phase-out of such immediate deduction if such expenses exceed $50,000. Expenditures that do not qualify to be immediately expensed can be amortized (i.e., deducted) over a period of 15 years.
- **Section 1202 stock**: As an incentive to encourage investment in start-up businesses, non-corporate taxpayers may generally exclude 50% of the gain from selling "qualified small business stock" that was acquired at original issue and held for more than 5 years (100% through 2013). The exclusion is limited to stock of a C corporation whose gross assets do not exceed $50 million (and that meets certain active business requirements).
- **Passive activity loss rules**: The passive activity loss rules prevent taxpayers from using losses from certain passive investments to offset their taxable income from other sources, such as salary income. If a taxpayer has a net loss from passive investments for the year, that loss is carried forward and is available to offset any income from passive sources that the taxpayer reports in future years.

Following are potential reform options for smaller businesses related to these provisions:

1. **Eliminate the requirement that smaller businesses depreciate and amortize investments**

    a. Permanently increase the amount of qualifying property that smaller businesses can immediately expense under Section 179 and index the amounts for inflation. For example, allow companies to expense up to $250,000, phasing out above $800,000 (The Ways and Means Committee Discussion Draft to Reform The Taxation of Small Businesses and Passthrough Entities; President's Framework for Business Tax Reform, February 2012 (proposing $1 million threshold); S.12, Job Creation Act of 2011, sponsored by Sen. Portman)
    b. Permit smaller businesses to expense an unlimited amount of qualified property under Section 179 (S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich)
    c. Include certain off-the-shelf computer software and qualified real property in the definition of qualifying property for purposes of Section 179 (S.12, Job Creation Act of 2011, sponsored by Sen. Portman; The Ways and Means

Committee Discussion Draft to Reform The Taxation of Small Businesses and Passthrough Entities)

2. Simplify tax accounting for smaller businesses

a. Expand cash method accounting and, potentially, expensing through one of the following options:
   i. Allow smaller businesses with, for example, up to $10 million in gross receipts to use a "business cash flow tax" model. In such a system, all business cash receipts are immediately included as income and all business cash disbursements are immediately deductible as expenses. Accordingly, the purchase of inventory, equipment, buildings and even land are immediately deductible. Such a system completely eliminates the need to account for inventories and depreciate business property (President's Advisory Panel on Tax Reform, 2005)
   ii. Same as (i), above, except businesses could not immediately expense buildings and land (President's Advisory Panel on Tax Reform, 2005)
   iii. Permit businesses with, for example, up to $10 million in gross receipts to use the existing cash method of accounting for income and expenses unless the business has inventory (The Ways and Means Committee Discussion Draft to Reform The Taxation of Small Businesses and Passthrough Entities)

b. Simplify the accounting rules for costs of inventory through one of the following options:
   i. Allow businesses with, for example, up to $10 million in gross receipts to expense all costs of inventory (including both direct and indirect costs) (President's Advisory Panel on Tax Reform, 2005)
   ii. Exempt all businesses with, for example, up to $10 million in gross receipts from the uni-cap rules though still require those businesses to capitalize direct costs of inventory (The Ways and Means Committee Discussion Draft to Reform The Taxation of Small Businesses and Passthrough Entities)

3. Innovation (R&D)

a. Allow smaller businesses to use up to, for example, $250,000 in R&D credits against their payroll tax liability, thereby making the credit partially refundable (Testimony of Annette Nellen at Senate Finance hearing on Tax Reform Options:

Incentives for Innovation on September 20, 2011; S.3460 of 112th, Startup Innovation Credit Act of 2012, sponsored by Sen. Coons)

4. Start-up and organizational business expenditures

a. Consolidate the rules for deducting start-up expenditures and organizational expenditures into a single rule, and increase the $5,000 threshold to $10,000 subject to a phase-out beginning at $60,000 (The Ways and Means Committee Discussion Draft to Reform The Taxation of Small Businesses and Passthrough Entities)

5. Exclusion for sale of qualified small business stock

a. Make 100% exclusion permanent and eliminate corresponding AMT preference item (Kauffman Foundation, A Market-Based Approach for Crossing the Valley of Death, January 2012)
b. Expand eligibility for Section 1202 by, for example, increasing the size restriction of the business to $75 million (S.1381, Small Business Tax Relief Act of 2009, sponsored by Sen. Grassley)
c. Expand eligibility for Section 1202 to limited liability companies and S corporations (Testimony of Annette Nellen at Senate Finance hearing on Tax Reform Options: Incentives for Innovation on September 20, 2011)

6. Exemption from passive activity loss rules for R&D-focused start-up businesses

a. Exempt R&D-focused pass-through entities from the passive activity loss rules to help them raise capital (S.3595 and H.R.6559, ...to provide an exception from the passive loss rules for investments in high technology research small business pass-thru entities, sponsored by Sen. Menendez and Rep. Gerlach)

7. Provide a pass-through business deduction

a. Allow some or all pass-through businesses to deduct a certain percentage of their business income (S.1381, Sen. Grassley's 2009 Small Business Tax Relief Act; S.1960, 2011 Jobs Creation Act, cosponsored by Sens. Collins and McCaskill; and H.R.9, 2012 Small Business Tax Cut Act, sponsored by Rep. Cantor)

II. DEPRECIATION AND AMORTIZATION

Under current law, businesses generally cannot immediately expense the cost of tangible property used in their business, but rather must "capitalize" the cost of such property and recover it over time through depreciation deductions. The same is true of intangible property, although deductions in that case are called "amortization."

The Tax Reform Act of 1986 introduced the current modified accelerated cost recovery system (MACRS) for computing depreciation. The cost of property is depreciated over its applicable recovery period, which is based on designated "class lives". Such recovery periods are generally shorter than the economic life of the asset. Some assets, such as buildings, are depreciated in equal amounts over the recovery period of the asset (straight-line depreciation). Other assets, such as equipment, are depreciated more quickly over the recovery period of the asset (e.g., the double declining balance method). In general, intangible assets (for example, goodwill and patents) are amortized on a straight-line basis over 15 years. However, certain expenditures for intangible assets, such as advertising, are deducted in the year paid or incurred even though they may create value that lasts beyond the current year.

In addition to the normal MACRS rules, an alternative depreciation system (ADS) was also enacted in 1986 for certain limited purposes. Taxpayers can elect to use ADS, in place of MACRS, as their regular depreciation method. Under ADS, property is depreciated over longer periods than MACRS using the straight-line method. Many of the class lives and asset classifications for MACRS and ADS have not been updated since the 1980s.

Following are potential reform options for depreciation and amortization:

1. **Revise the depreciation rules for tangible assets to more closely track their economic lives through one of the following reforms:**

    a. Require companies to use the ADS rules (S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich; President's Economic Recovery Advisory Board's Report on Tax Reform Options, August 2010; estimated in 2011 to raise $724 billion over 10 years)
    b. Require companies to use the ADS rules with updated lives and modifications for new technologies; possible sources for updated lives include the Treasury Department and the Bureau of Economic Analysis (S.2100, Tax Depreciation, Modernization, and Simplification Act of 2005, sponsored by Sen. Smith)
    c. Extend the recovery period of equipment under MACRS to reflect the decline in inflation since 1986 but keep the existing depreciation methods (CBO, Reducing

the Deficit: Spending and Revenue Options, March 2011; estimated to raise $241 billion over 10 years)

d. Require publicly-traded companies and large, audited companies to compute depreciation under GAAP (i.e., "book depreciation") (Murray, Tax Executives Institute (TEI), Comments of TEI on Tax Simplification and Reform, March 25, 1997; Whitaker, Bridging the Book-Tax Gap, Yale Law Review, 2005)

2. **Revise the amortization rules for intangible assets to more closely track the economic lives of intangible assets**

   a. Extend the useful life of intangibles to, for example, 20 years (Johnson, Extend the Tax Life for Acquired Intangibles to 75 Years, Tax Notes, May 21, 2012)
   b. Require companies to amortize certain expenditures currently permitted to be expensed, such as advertising expenses (The Committee for a Responsible Federal Budget, Sept 2012; CBO, Options for Reducing the Deficit, 1997)

3. **Allow 100% expensing** (President's Advisory Panel on Tax Reform, 2005)

   a. Allow businesses otherwise eligible for 100% expensing to elect to accelerate alternative minimum tax (AMT) credits instead (S.2240, a bill to amend the Internal Revenue Code of 1986 to extend the allowance for bonus depreciation for certain business assets, a proposal tying AMT in lieu of bonus to 100% expensing by Sens. Stabenow, Blunt, Brown and Roberts)

III. MANUFACTURING

Under current law, businesses can deduct up to 9% (6% for oil and gas businesses) of their income from domestic manufacturing and production (Section 199). By its nature, this provision reduces the marginal and average tax rate of certain businesses.

1. **Repeal the domestic production deduction (Section 199)** (CBO, Reducing the Deficit: Spending and Revenue Options, March 2011; President's Economic Recovery Advisory Board's Report on Tax Reform Options, August 2010; H.R.3970, Tax Reduction and Reform Act of 2007, sponsored by Rep. Rangel; Robert Shapiro, Progressive Policy Institute Policy Memo, Anatomy of a Special Tax Break & The Case for Broad Corporate Tax Reform, March 2013; estimated in 2011 to raise $164 billion over 10 years)

2. **Target or simplify the domestic production deduction through some or all of the following reforms:**

    a. Limit the deduction to manufacturing and industries that can relocate abroad, for example by disallowing the deduction for some or all of the following: film, utilities, construction, engineering and architectural services, natural resource extraction and agriculture (President's Framework for Business Tax Reform, February 2012)
    b. Provide a larger deduction (or increased R&D credit) on income from products where the related R&D is performed within the U.S. (Testimony of Michael Rashkin at Senate Finance hearing on Tax Reform Options: Incentives for Innovation on September 20, 2011; S.1866 of 112th, AGREE Act, Sen. Coons; CRS, The Section 199 Production Activities Deduction: Background and Analysis)
    c. Provide a larger deduction for income from advanced manufacturing activities, such as activities that depend on information, automation, computation, software, sensing, or networking, or for cutting-edge technology (President's Framework for Business Tax Reform, February 2012; proposal by Sen. Brown)
    d. Provide the same percentage deduction for all domestic production activities, including oil and gas (Merrill Matthews, About Those Tax Breaks for Big Oil . . ., Wall St. J. A17, April 3, 2013)

IV. INNOVATION

Under current law, businesses can choose to immediately expense R&D costs or amortize such costs over 5 years or more. In addition, businesses can claim a nonrefundable credit for incremental spending on labor and supplies used for research. Businesses can choose between two forms of the R&D credit: (1) the "traditional" credit, which is calculated by comparing current research expenses to those between 1984 and 1988, and (2) the "alternative simplified credit," which is calculated by comparing current research expenses from the past three years. The R&D credit has always been temporary and currently expires at the end of 2013. It is often difficult for businesses to successfully claim the credit for all their research activities because of the complex rules regarding what activities or costs qualify for the credit.

1. **Allow the R&D credit to expire** (Sullivan, Time to Scrap the Research Credit, Tax Notes, February 16, 2010)

2. **Require companies to amortize R&D costs over, for example, 3 years rather than expensing costs immediately** (Tyson and Linden, The Corporate R&D Tax Credit and U.S.

Innovation and Competitiveness, Center for American Progress, 2012; estimated in 2011 to raise $160 billion over 10 years)

3. **Make the R&D credit permanent, while simplifying and/or better targeting it through some or all of the following reforms:**

   a. Eliminate the traditional credit and increase the alternative simplified credit to, for example, 17-20% (S.1577 of 112th, GROWTH Act, sponsored by Chairman Baucus and Ranking Member Hatch; Administration's Fiscal Year 2013 Revenue Proposals; Testimony of Annette Nellen at Senate Finance hearing on Tax Reform Options: Incentives for Innovation on September 20, 2011; Administration's proposal estimated in 2012 to cost $99 billion over 10 years)
   b. Increase the credit amount for certain research activities like breakthrough innovative or life sciences research (Testimony of Michael Rashkin at Senate Finance hearing on Tax Reform Options: Incentives for Innovation on September 20, 2011; S.1410, Life Sciences Jobs and Investment Act of 2011, sponsored by Sen. Casey)
   c. Eliminate the incremental-only aspect of the credit so it applies to all qualified research (Testimony by Dirk Pilat, the Organisation for Economic Cooperation and Development, discussing other countries' approaches at Senate Finance hearing on Tax Reform Options: Incentives for Innovation on September 20, 2011)
   d. Disallow supplies from definition of research expenses (Michael Rashkin in his addendum to his testimony at Senate Finance hearing on Tax Reform Options: Incentives for Innovation on September 20, 2011)

4. **Adopt a patent box**

   a. Adopt a "patent box" that taxes business income from the sale of patented products developed in the U.S. at lower rates (S.2091, United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi, Testimony of Robert Atkinson before Senate Finance Hearing on Tax Reform Options: Incentives for Capital Investment and Manufacturing on March 6, 2012; Leveling the Playing Field Act of 2012, Sen. Feinstein)

V. OTHER TAX ACCOUNTING

Inventory. Under current law, businesses generally may not deduct the cost of goods in inventory until the inventory is sold. Businesses can elect one of several methods for deciding which specific inventory item is deemed to be sold, which matters when items of the same good were purchased at different prices. Under first-in, first-out (FIFO), the business deducts the cost of goods in the order in which they were acquired. Under last-in, first-out (LIFO), the business deducts the cost of the most recently acquired goods first. Under weighted average, the business deducts the average cost of goods available for sale during the period, while under specific identification, the business deducts the cost of the specific product being sold. If prices rise over time, LIFO accounting results in less taxable income. If a business adopts LIFO accounting for tax purposes, it must also use LIFO for financial accounting purposes. The International Financial Reporting Standards, which are used in many foreign jurisdictions, do not permit LIFO accounting.

In addition to picking the method of calculating inventory (e.g., LIFO, FIFO, etc.), taxpayers must also pick a method of valuing inventory. There are three methods for valuing inventory: cost, the lower of cost or market and retail pricing.

Like-kind exchanges. In some circumstances, taxpayers are allowed to defer gains on business or investment property when it is traded for similar property. In addition to permitting direct swaps of property, current law allows certain "three-cornered transactions" in which taxpayers can use intermediaries to facilitate the acquisition of similar property. If, however, a taxpayer sells property and reinvests the proceeds in similar property outside of the like-kind exchange rules, the taxpayer must pay tax immediately on the sale even though the end result is the same.

Insurance. Insurance companies are generally taxed as corporations, except that the reserves they hold to meet policyholder obligations or pay claims are deductible when established rather than when the claim is paid. The tax code permits this deduction in recognition of the fact that insurance companies take premiums into income when they are received, while the related claim may not be paid for years.

The tax code contains numerous rules regarding the computation of the reserve deduction. While insurance companies use their state-mandated reserves as the starting point for determining the amount of their reserve deduction, they must make adjustments to that starting point. For example, they have to adjust for the time value of money if there is a delay in paying claims, and for the benefit of funding reserves with tax-preferred income. Many aspects of these adjustments are classified by JCT as tax expenditures.

The rules governing insurance taxation have not been significantly reformed since 1986. Since then, many more insurance companies have become publicly traded. The federal government has become more active in overseeing the financial solvency of insurance companies through the Treasury Department's Federal Insurance Office and Dodd-Frank. And technology has enabled insurance actuaries to more accurately predict long-term liabilities. Many of the options listed below involve revisiting insurance taxation in light of these developments.

1. **Repeal last-in, first-out (LIFO) inventory accounting through one of the following options:**

    a. Require companies using LIFO accounting to convert to another method of inventory accounting and recognize the gain from recapturing any LIFO reserves into income over a period of time. The effective date can be delayed to give companies time to plan for and minimize the tax consequences of conversion (CBO, Reducing the Deficit: Spending and Revenue Options, March 2011; Administration's Fiscal Year 2013 Revenue Proposals; Administration's proposal estimated in 2012 to raise $67 billion over 10 years)
    b. Require companies using LIFO accounting to switch prospectively for newly acquired inventory to another method of inventory accounting (CBO, Reducing the Deficit: Spending and Revenue Options, March 2011)

2. **Repeal the lower of cost or market inventory rules** (S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sens. Wyden, Coats, and Begich; estimated in 2012 to raise $3 billion over 10 years)

3. **Repeal, tighten or simplify the like-kind exchange deferral rules**

    a. Repeal the like-kind exchange rules (President's Economic Recovery Advisory Board's Report on Tax Reform Options, August 2010, estimated in 2011 to raise $18 billion over 10 years)
    b. Tighten the rules, for example, by repealing like-kind exchanges for transactions involving three-cornered exchanges and only allowing tax deferral where exchanges are directly between two parties (President's Economic Recovery Advisory Board's Report on Tax Reform Options, August 2010)
    c. Replace the like-kind exchange rules with an election to defer paying tax on gains from selling property if the sales proceeds are rolled over into similar

replacement property within a limited timeframe (President's Economic Recovery Advisory Board's Report on Tax Reform Options, August 2010)

4. **Update insurance company tax rules to account for industry innovations and to more closely match income and statutory accounting**

   a. Life insurance companies
      i. Adjust the rules governing the amount of a life insurance company's reserves that are deductible to more closely align with statutory reserves the company is required to hold by state regulators (DesRochers and Hertz, Treading into the Thicket: Federal Income Tax Implications of Principles-Based Reserves, Society of Actuaries, April 19, 2007; Adney, Taxing Time, The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System, Society of Actuaries, May 2006)
      ii. Change the calculation of a life insurance company and policyholder's share of dividends received and tax exempt interest (General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals)
      iii. Adjust current statutory deferred acquisition cost rates that reflect amount of policy acquisition costs that must be amortized (General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals)
      iv. Repeal the small life insurance company deduction (Landy, Introducing the "Dirty Dozen" Tax Breaks, The Century Foundation, 2012)
   b. Non-life insurance companies
      i. Adjust current loss reserve discounting rules (General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals)
   c. All insurance companies
      i. Repeal some or all of the life-nonlife consolidated return limitations (H.R.3399, To amend the Internal Revenue Code of 1986 to permit the consolidation of life insurance companies with other companies (111th Congress), sponsored by Rep. Larson)

ECONOMIC AND COMMUNITY DEVELOPMENT

Senate Finance Committee Staff Tax Reform Options for Discussion

May 15, 2013

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CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The federal tax code includes a number of tax expenditures related to economic and community development. Some tax expenditures help state, local and tribal governments build infrastructure such as highways, airports, schools, and hospitals. Other tax expenditures are for homeownership or affordable rental housing for low-income households. Still others are for businesses to invest in impoverished and difficult-to-develop areas.

Tax reform provides an opportunity to simplify tax expenditures for economic and community development and, if members of Congress decide to preserve these provisions, make them more effective. Following are some potential broad principles for reform in this area:

- Simplify the law in order to reduce the cost to businesses and individuals of complying with the tax code
- Carefully consider whether and how to address any positive or negative externalities
- If policy makers choose to include incentives in a reformed tax code, make such tax expenditures more equitable and efficient
- Carefully consider how to treat different parts of the country and industries equitably

Some specific concerns about the taxation of housing, state, local and tribal finance, and community development include the following:

- **Distortion of investment decisions:** Some argue that tax expenditures, for example for housing, distort investment choices, which may hamper economic growth, and believe that the tax code should instead focus on equitably and efficiently collecting revenues. To the extent state and local governments and the private sector already provide sufficient capital for a good or service, federal tax incentives could be unnecessary and lead to over-provision of the good or service. Others argue that that tax incentives promote efficiency where they account for externalities. For example, they argue that homeownership has positive effects on neighborhood investment, and therefore tax incentives are appropriate. However, externalities may be hard to measure precisely.

- **Low bang-for-the-buck for tax incentives:** Some argue that tax incentives in this area could achieve more at a lower cost. For example, tax-exempt bonds are intended to reduce the borrowing costs to state and local governments by providing a tax exemption for investors on the interest they receive. However, according to the Congressional Budget Office (CBO), about 20% of the tax subsidy does not accrue to the state and local government by lowering their borrowing costs.

- **Uncertainty created by temporary extensions:** Some are concerned that the temporary nature of expiring tax expenditures creates uncertainty for taxpayers, makes it difficult for businesses to plan and may diminish their effectiveness. For example, the New Markets Tax Credit has been extended 5 times since it was created in 2000. At the same time, some argue that certain tax expenditures should expire to ensure that the tax code adapts to changing circumstances.

- **Fairness:** Some are concerned that tax expenditures in this area, for example for homeownership, are inequitable because higher-income households receive larger tax incentives than lower-income households. For example, more than two-thirds of taxpayers do not itemize and therefore do not benefit from the mortgage interest deduction. These non-itemizers are generally middle-income and low-income. However, others note that itemizers tend to bear a larger portion of the tax burden and view the standard deduction as a simplification to avoid the need to itemize.

- **Effect on household debt accumulation:** Over the last 40 years, inflation-adjusted, per-capita mortgage debt has more than doubled according to the Federal Reserve. Some are concerned that tax expenditures for homeownership have contributed to this increase, and that households are less financially stable as a result.

- **Duplication with spending programs:** Some argue that the tax system should not subsidize, for example, community development projects because direct spending programs can be more narrowly targeted and lead to more accountability and transparency. However, others argue that tax expenditures can be more effective or efficient than direct spending programs in certain circumstances. At a minimum, many believe that tax benefits and direct spending benefits, such as the Low-Income House Tax Credit and Section 8 housing assistance, should be more coordinated.

- **Federalism:** Some believe that it is not an appropriate role for the federal government to assist state and local governments by, for example, helping to pay for local infrastructure or services. Others argue that such assistance has spillover effects beyond the local community, and therefore the federal government should play a role.

- **State revenue needs:** Some states have found it difficult to maintain a given level of services during economic downturns because, unlike the federal government, almost all states are required by state law to balance their budgets. As a result, they cannot meet their operating budgets by using borrowed funds. Other states have not found it difficult to maintain services during economic downturns because of spending restraint or other policy changes. Some states are also concerned about their ability to collect the level of revenues they would like going forward, as a result of changes in the economy or federal restrictions on what taxes they can impose. Some believe the federal government should impose fewer restrictions on what states may tax and do more to facilitate states collecting taxes they are owed. Others, however, are concerned that doing so might result in states overreaching their taxing jurisdiction, expanding the scope of their taxes or hindering economic growth.

- **Complexity and uncertainty created by multiple states' tax rules:** Each state and locality generally has the authority to determine the level of and type of taxes within its jurisdiction. This can create a large amount of complexity and uncertainty for businesses and individuals who are subject to tax in multiple states and localities. For example, a business operating in all 50 states may have to contend with over 9,600 different sales taxes and income tax withholding requirements for their employees.

Given the advent and expansion of electronic commerce and the digital goods and service industries, there is greater uncertainty as to what constitutes a transaction, and whether and how it should be taxed. Some argue coordination and uniformity of state rules could provide taxpayers with certainty as to whom and what is subject to a tax. Others are concerned about whether this is an appropriate role for the federal government.

REFORM OPTIONS

I. HOUSING

The federal tax code includes three major tax expenditures for homeowners: the home mortgage interest deduction, the exclusion of gain on the sale of a home, and the deduction for real property taxes (discussed in the next section).

The home mortgage interest deduction is an itemized deduction for taxpayers paying mortgage interest on owner-occupied housing, for up to two residences. Taxpayers can claim it for interest on mortgages totaling up to $1 million and also on home equity loans up to $100,000, regardless of the use of the funds. Under the individual alternative minimum tax (AMT), a taxpayer may lose part or all of the interest deduction on home equity loans. A temporary provision, scheduled to expire at the end of 2013, also allows some taxpayers to claim the deduction for mortgage insurance premiums.

The exclusion for gain on the sale of a home allows taxpayers to exclude up to $250,000 ($500,000 for married couples filing jointly) in gains from the sale of their principal residence. To qualify for the exclusion, the seller must have both owned and lived in the house for at least two of the previous five years. Exceptions are provided under certain circumstances, such as moving for employment purposes or living in a nursing home.

The federal tax code also provides for a tax credit and tax-exempt bond financing for affordable rental housing. The low-income housing tax credit (LIHTC) is administered by state housing finance authorities through a competitive application process open to developers of rental housing for low-income households. In addition, a limited number of tax-exempt bonds are available in each state to finance affordable rental housing.

1. **Gradually repeal the mortgage interest deduction** (Testimony of Dr. Karl Case before the Finance Committee, October 6, 2011; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," 2011; similar to U.K. law)

    a. Could be phased out by, for example:
        i. Reducing the maximum mortgage eligible for the deduction by, for example, $100,000 for each of 10 years (estimated in 2011 to raise $215 billion over 10 years)
        ii. Limit the value of the deduction to, for example, 25% per dollar deducted, with the percent declining over time

2. **Limit the mortgage interest deduction**

    a. Reduce the value of the mortgage interest deduction for higher-cost homes
        i. Reduce the amount of qualified debt from $1 million to, for example, $500,000 (The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," 2010; Congressional Budget Office, "Budget Options," 2007, estimated in 2007 to raise $88 billion over 10 years if limited to $400,000)
        ii. Limit eligible interest on mortgages to, for example, 125% of the average regional price of housing (Testimony of Sen. John Breaux before the Finance Committee, October 6, 2011; President's Advisory Panel on Tax Reform, "Final Report," 2005)
    b. Reduce the mortgage interest deduction in various ways
        i. Limit the value of the deduction to, for example, 28% per dollar deducted (FY14 Administration Budget Proposal)
        ii. Repeal deduction for interest paid on home equity indebtedness (President's Advisory Panel on Tax Reform, "Final Report," 2005; Joint Committee on Taxation, "Options To Improve Tax Compliance And Reform Tax Expenditures," 2005, estimated in 2005 to raise $23 billion over 10 years)
        iii. Deny deduction for second homes, boats, and campers (President's Advisory Panel on Tax Reform, "Final Report," 2005; Rivlin-Domenici, "Restoring America's Future," 2010; Viard, "Replacing the Home Mortgage Interest Deduction," 2013)

3. **Convert the mortgage interest deduction to an above-the-line deduction** (H.R.3608 (110th Congress), To … allow the deduction for interest on acquisition indebtedness on principal residences to all individuals…, sponsored by Rep. Barrow)

4. **Convert the mortgage interest deduction to a credit** (President's Advisory Panel on Tax Reform, "Final Report," 2005; Rivlin-Domenici, "Restoring America's Future," 2010; H.R.1213 (113th Congress), Common Sense Housing Investment Act of 2013, sponsored by Rep. Ellison; Viard, "Replacing the Home Mortgage Interest Deduction," 2013)

    a. Credit could be a percentage of mortgage interest or could be a flat dollar amount
    b. Credit could be refundable or nonrefundable
    c. Could gradually phase-out current itemized deduction and transition to the credit over a period of years
    d. Credit could be limited to first-time homeowners

5. **Phase out exclusion for capital gains on sale of principal residence** (Congressional Research Service, "The Exclusion of Capital Gains for Owner-Occupied Housing," 2007)

    a. Phase out exclusion over, for example, 10 years
    b. Allow taxpayer to spread gain over, for example, 5 years

6. **Make permanent the deduction for mortgage insurance premium payments** (S.688 (113th Congress), A bill to permanently extend the private mortgage insurance tax deduction, sponsored by Sens. Stabenow and Crapo)

7. **Extend exclusion from income for cancellation of certain home mortgage debt**

    a. Could do so permanently (Testimony of Gary Thomas before the Committee on Ways and Means, April 25, 2013), or
    b. Temporarily, for example, through 2016 (FY14 Administration Budget Proposal; S.2250 (112th Congress), The Mortgage Forgiveness Tax Relief Act, sponsored by Sens. Stabenow, Brown, Cardin, Isakson, Menendez, and Nelson; estimated in 2013 to cost $6 billion over 10 years)

8. **Repeal the Low-Income Housing Tax Credit (LIHTC)** (President's Economic Recovery Advisory Board, "The Report on Tax Reform Options," 2010)

9. **Replace the LIHTC with an equivalent reduction in tax on rental income** (Testimony of Mark A. Calabria, before Committee on Ways and Means, April 25, 2013)

10. **Reform or expand the LIHTC** (FY14 Administration Budget Proposal; S.1989 (112th Congress), A bill to… make permanent the minimum low-income housing tax credit rate …, sponsored by Sens. Cantwell, Bingaman, Brown, Cardin, Crapo, Kerry, Menendez, Nelson, Schumer, Snowe, and Stabenow; H.R.2765 (105th Congress), To… specify certain circumstances… for purposes of denying eligibility for the low-income housing tax credit, sponsored by Rep. Hilliard; Roden, "Building a Better Low-Income Housing Tax Credit," Tax Notes, 2010; Joint Center for Housing Studies of Harvard University, "The Disruption of the Low-Income Housing Tax Credit Program," 2009)

    a. For example, allow states to use amounts allocated for private activity bonds for LIHTCs instead, adjust and freeze the discount rate for the LIHTC, prohibit awarding of credits to nonprofits controlled by for-profit entities, limit the number of LIHTC units per project, or eliminate the provisions in current law allowing for enhanced credits for projects in certain geographic areas

11. **Create a non-refundable tax credit for low-income renters** (Center on Budget and Policy Priorities, "Renters' Tax Credit Would Promote Equity and Advance Balanced Housing Policy," 2012)

    a. Credit could go to property owners that reduced rents for low-income renters generally to no more than 30% of their income
    b. Could cap amount of federal credits for allocation by states at, for example, $5 billion
    c. Alternatively, could replace the LIHTC with a voucher program for low-income renters (Weisbach, "Tax Expenditures, Principal-Agent Problems, and Redundancy," Washington University Law Review, 2006)

II. STATE AND LOCAL FINANCING

Under current law, taxpayers who itemize can deduct the amount they pay in state and local income and property taxes. A temporary provision, scheduled to expire at the end of 2013, allows taxpayers to choose to deduct their state and local sales taxes instead of their state and local income taxes. There is no limit on the amount of state and local real property taxes that can be deducted or from which properties, so owners of multiple homes can deduct the taxes assessed on all of them. However, under the individual AMT, a taxpayer may lose the deduction for state and local taxes.

In addition, taxpayers who hold bonds issued by state and local governments for governmental purposes ("governmental bonds") do not have to pay tax on the interest they receive on the bond. The same is true for certain bonds issued by the private sector ("private activity bonds"). Another tax-preferred bond is the tax credit bond, which state and local governments and certain tax-exempt organizations can issue for specific projects such as school construction, renewable electricity generation, and energy efficiency programs. Issuers of tax credit bonds do not pay interest on the bond. Instead, the investor holding the bond as of a certain date receives a quarterly tax credit. In 2009, Congress created a new type of tax subsidy for bonds to finance governmental capital projects, the Build America Bond. This provision provided a direct interest payment subsidy to state and local government issuers for bonds issued, instead of an exclusion or tax credit for the investors. Authority to issue Build America Bonds expired on December 31, 2010. Under the AMT, taxpayers are subject to tax on interest on specified private activity bonds.

1. **Limit or eliminate the deduction for state and local taxes**

    a. Repeal the deduction (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," 2011; President's Advisory Panel on Tax Reform, "Final Report," 2005; estimated in 2011 to raise $862 billion over 10 years)
    b. Limit the value of the deduction to, for example, 28% of each dollar deducted (FY14 Administration Budget Proposal)
    c. Cap the deduction at, for example, 2% of adjusted gross income (Testimony of Frank Sammartino before the Finance Committee, April 25, 2012; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," 2011; Feldstein, "It's Time to Cap Tax Deductions," 2013; estimated in 2011 to raise $629 billion over 10 years)
    d. Allow non-itemizers to claim the deduction for state and local real property taxes or all state and local taxes (S.3125 (110th Congress), Energy Independence and Tax Relief Act of 2008, sponsored by Sen. Baucus; S.22 (112th Congress), Homeowner Tax Fairness Act of 2011, sponsored by Sen. Gillibrand)

2. **Permanently extend the deduction for state and local sales tax** (S.41 (113th Congress), A bill to provide a permanent deduction for state and local sales taxes, sponsored by Sens. Cantwell, Enzi, Nelson, and Johnson)

3. **Repeal the tax exemption on all governmental and private activity bonds** (The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," 2010)

4. **Modify existing tax-exempt bonds**

    a. Repeal the governmental ownership requirement for bonds used to finance airports, docks and wharves, and mass commuting facilities (FY14 Administration Budget Proposal; estimated in 2013 to cost $4 billion over 10 years)
    b. Eliminate private payment test for stadium bonds (Joint Committee on Taxation, "Options To Improve Tax Compliance And Reform Tax Expenditures," 2005; estimated in 2005 to raise $1 billion over 10 years)

5. **Create a new, permanent direct subsidy for bonds for financing governmental capital projects** (FY14 Administration Budget Proposal; Testimony of Governor Ed Rendell before the Finance Committee, May 17, 2011; estimated in 2013 to raise $4 billion over 10 years)

    a. Could expand to include projects and programs eligible for private activity bond financing and subject to state bond volume caps (FY14 Administration Proposal)

6. **Replace the exclusion for interest on state and local bonds with a direct subsidy for the issuer or a non-refundable tax credit for the investor** (S.727 (112th Congress), The Bipartisan Tax Fairness and Simplification Act, sponsored by Sen. Wyden; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," 2011; estimated in 2011 to raise $143 billion over 10 years)

    a. State and local issuers would receive a direct federal subsidy equal to, for example, 25% of the interest paid on the bonds
        i. Alternatively, investor would receive non-refundable credit of that amount
    b. For qualified private activity bonds, states and localities could pass the subsidy payment on to the private sector borrower
    c. Could phase out exclusion for newly-issued bonds over, for example, 3 years

III. TRIBAL FINANCING

Indian tribes and wholly-owned tribal corporations chartered under Federal law are not subject to Federal income taxes. In contrast, a corporation owned by a tribe or tribal members and organized under State law is subject to Federal income tax on income earned from commercial activities conducted on or off the tribe's reservation. Generally, tribal members are subject to

Federal income taxes except for certain income. For example, income earned from the exercise of certain fishing rights is excluded from income.

Tribes are often depressed economic communities with high unemployment. From 2007 to 2010, the American Indian unemployment rate increased from 7.5% to 15.2%. The unemployment rate for Alaska Natives was even higher—21.3% in 2010. The tax code contains several provisions to boost economic activity within and on tribal lands. Tribes are also allowed to issue tax-exempt bonds; however, such bonds are limited to "essential government functions", a requirement that does not apply to states.

1. **Modify tribal tax-exempt bonds**
    a. Modify tax-exempt bonds for tribal governments (FY14 Administration Budget Proposal; estimated in 2013 to cost less than $1 billion over 10 years; Joint Committee on Taxation, JCX-19-05R, 2005)
        i. Repeal the essential governmental function requirement so that eligibility standards are the same for tribal governments and state and local governments (Testimony of Dr. Lindsay Robertson before the Finance Committee, May 15, 2012; Department of the Treasury, "Report and Recommendations to Congress Regarding Tribal Economic Development Bond Provision under Section 7871 of the Internal Revenue Code," 2011)
        ii. Conform private activity bond standard to those of state and local governments
            1. Could restrict project location to reservations
            2. Could prohibit issue or use of bonds for gambling facilities

2. **Exempt certain tribal activities from taxation**

    a. Create a ten-year, tax-free zone for selected areas of Indian country in which economic activity would not be subject to any federal, state, or local income, sales, or excise taxes (Testimony of President Robert Odawi Porter before the Finance Committee, May 15, 2012; Lummi Indian Business Council comments to Committee on Ways and Means working group on Charitable/Exempt organizations, submitted April 15, 2013)

3. **Clarify the general welfare exclusion doctrine for certain benefits provided by tribes to members** (Various Tribal comments to Committee on Ways and Means working group on Charitable/Exempt organizations, submitted April 15, 2013)

a. Codify the income exclusion for government benefits provided by Indian tribes under the general welfare exclusion doctrine
b. Adopt a moratorium on audits relating to the general welfare exclusion doctrine while implementing Notice 2012-75

4. Make permanent or expand temporary provisions

a. Make permanent the Indian employment credit and accelerated depreciation on Indian reservations (Choctaw Nation of Oklahoma comments to Committee on Ways and Means working group on Charitable/Exempt organizations, submitted April 15, 2013)
b. Expand the Indian employment tax credit to more closely resemble the Work Opportunity Tax Credit (Testimony of Donald Laverdure before the Finance Committee, July 22, 2008)

5. Conform the definition of Indian and reservation for tax purposes (Testimony of Director D'Shane Barnett before the House Appropriations Subcommittee on the Interior, Environment, and Related Agencies, March 19, 2013)

6. Modify the adoption tax credit to allow Tribal Governments to determine whether a child has special needs (FY14 Administration Budget Proposal; estimated in 2013 to cost less than $1 billion over 10 years)

IV. COMMUNITY DEVELOPMENT

The federal tax code provides incentives for investment in areas of the country with high levels of poverty and economic distress. The New Markets Tax Credit is administered by the Community Development Financial Institutions Fund of the Department of the Treasury, which competitively allocates a Congressionally-established amount of tax credit authority to community development entities. The program provides investors in such entities with a tax credit over seven years totaling 39% of the investment. To qualify, community development entities must invest in qualifying low-income census tracts. The American Taxpayer Relief Act of 2012 provided $7 billion in allocation authority for the program over two years. Under current law, the New Markets Tax Credit can be used to offset regular federal income tax liability but cannot be used to offset AMT liability.

Congress has also designated certain geographic areas as Empowerment Zones, Enterprise Communities and Renewal Communities. These areas were eligible for federal grants and tax incentives. Tax provisions for these geographic areas included employment tax credits, deductions, tax-exempt financing and other tax incentives. The tax benefits for Empowerment Zones expire at the end of 2013 while the other zone incentives have already expired.

To encourage the preservation of historic buildings, current law provides a tax credit equal to 10% of the cost of rehabilitating structures built before 1936 and 20% for structures certified by the National Park Service as historic structures.

Several tax benefits are automatically available to Presidentially-declared disasters areas, including granting additional time to file returns and pay taxes and allowing both individuals and businesses to receive a faster refund by claiming losses related to the disaster on the tax return for the previous year, usually by filing an amended return. Since 2001, Congress has passed legislation on four separate occasions to expand these tax benefits in response to specific Presidentially-declared disasters. These bills have provided various forms of additional tax relief for a limited period of time to individuals and businesses located in the disaster area in order to help the area recover. Disasters have included terrorist attacks, hurricanes, floods, and other natural disasters.

1. **Repeal the New Markets Tax Credit** (Sen. Coburn, "Back in Black," 2011)

2. **Extend and modify the New Markets Tax Credit** (FY14 Administration Budget Proposal; S.996 (112th Congress), New Markets Extension Act of 2011, sponsored by Sens. Rockefeller and Snowe; estimated in 2013 to cost $7 billion over 10 years)

    a. Permanently extend the New Markets Tax Credit
    b. Index the credit for inflation and allow it to offset AMT liability
    c. Prohibit any project benefitting from the New Markets Tax Credit from also receiving any other federal tax benefit, federal grant, or federal loan (Coburn Amendment #14 to Chairman's Mark of the Family and Business Tax Cut Certainty Act of 2012, S.3521 (112th Congress))
    d. Prohibit New Markets Tax Credits from being claimed by entities that received TARP funding (Coburn Amendment #15 to Chairman's Mark of the Family and Business Tax Cut Certainty Act of 2012, S.3521 (112th Congress))
    e. Prohibit New Markets Tax Credits from being used to support certain projects, such as fast food restaurants (Coburn Amendment #16 to Chairman's Mark of the Family and Business Tax Cut Certainty Act of 2012, S.3521 (112th Congress))

3. Modify or eliminate the Historic Preservation Tax Credit

a. Repeal the credit (Sen. Coburn, "Back in Black," 2011)
b. Reform the credit by, for example, increasing the credit to 30% for certain smaller projects and adding an energy-efficient supplement to the credit (S.2074 (112th Congress), Creating American Prosperity through Preservation Act of 2012, sponsored by Sens. Cardin, Schumer, Stabenow)

4. Create a permanent tax relief package for individuals and businesses in Presidentially-declared national disaster areas (S.3335 (110th Congress), Jobs, Energy, Families, and Disaster Relief Act of 2008, sponsored by Sens. Baucus and Reid; S.1456 (112th Congress), The Disaster Tax Relief Act of 2011, sponsored by Sens. Kerry and Brown)

a. Tax relief for individuals could include temporary suspension of limitations of charitable contributions, extended replacement period of property lost, exclusion of disaster-related cancellation of indebtedness, and waiver of penalties on distributions from retirement accounts
b. Tax relief for businesses could include employee retention credits, extended net operating losses, enhanced expensing, and eligibility for the New Markets Tax Credit

V. STATE AND LOCAL TAX UNIFORMITY

States and localities generally may determine the appropriate level and form of taxes they impose, although the Constitution includes restrictions on who and what states and localities can tax, including the Due Process Clause of the 14th Amendment and the Commerce Clause. The Due Process Clause requires a minimum connection between a state and the person, property, or transaction it seeks to tax. The Commerce Clause gives Congress the power to regulate commerce among the states, including the authority to allow states to impose taxes or require the states to conform or limit their taxes when those laws affect interstate commerce. Under the "dormant Commerce Clause" legal doctrine, states have generally been prohibited from enacting laws that improperly burden or discriminate against interstate commerce.

Currently, the federal government has limited involvement in state taxation, and there is little coordination and uniformity between state tax rules on who and what is subject to a tax. Changes that coordinate rules and promote uniformity across state boundaries could help reduce double taxation, tax evasion, and compliance burdens, while in some cases allowing states to better balance their budgets.

1. Exercise Federal authority to establish uniform rules among the states

a. Establish uniform, national rules for how digital goods and services are taxed (i.e., sourcing rules) (Amendment 764 to S.743 (113th Congress), the Digital Goods and Services Tax Fairness Act, as introduced by Sens. Thune and Wyden)
b. Create uniform, national rules for when a state can tax the income of, or require withholding on, an employee who is temporarily working in that state (S.3485 (112th Congress), Mobile Workforce State Income Tax Simplification Act, sponsored by Sen. Brown; Testimony of Walter Hellerstein before the Finance Committee, April 25, 2012)
c. Create uniform, national rules for when a state may tax compensation earned by nonresident telecommuters (S.1811 (112th Congress), Telecommuter Tax Fairness Act of 2011, sponsored by Sens. Lieberman and Blumenthal)

2. Authorize states to require out-of-state vendors to collect sales tax

a. Predicate such authority on the state becoming a member of the Streamlined Sales and Use Tax Agreement, which would require the state to reduce compliance burdens for out-of-state sellers through, for example, a centralized one-stop, multistate registration system; a single audit; uniform definitions of what can be taxed; and reimbursement of expenses incurred by a seller in collecting and remitting taxes (S.1452 (112th Congress) Main Street Fairness Act, sponsored by Sen. Durbin; Testimony of Walter Hellerstein before the Finance Committee, April 25, 2012)
b. Alternatively, predicate such authority on the state either becoming a member of the Streamlined Sales and Use Tax Agreement or adopting minimum simplification requirements, such as one filing location per state and a release from liability for reliance on state-provided compliance software (S.743 (113th Congress), the Marketplace Fairness Act of 2013, sponsored by Sens. Enzi, Durbin, and Alexander; Testimony of Sanford Zinman before the Finance Committee, April 25, 2012)

c. Require states to opt-in before resident businesses are subject to collection, with residence of business defined based on the residence of its owners and the share of domestic payroll in that state (Amendment 757 to S.743 (113th Congress), sponsored by Sen. Shaheen)
d. Modify the Marketplace Fairness Act by striking the preemption provision, sunsetting the legislation after 5 years, instituting 3 year statute-of-limitations on state audits of remote sellers, requesting a GAO study of ability of remote sellers to comply with the legislation, carving-out digital goods, providing vendor compensation, and increasing the small seller exemption and indexing it for inflation (Amendment 754 to S.743 (113th Congress), sponsored by Sen. Hatch)
e. Authorizing states to require out-of-state vendors to collect sales tax assumes destination-based sourcing (generally based on the location of the consumer), but state and local taxes could be collected on an origin basis (based on the location of the remote seller) (Cato Institute, "The Internet Tax Solution, Tax Competition, Not Tax Collusion," 2003)

3. Reform prohibitions on certain state or local taxes

a. Permanently extend the moratorium on Internet access taxes and the ban on multiple and discriminatory taxes on electronic commerce (S.31 (113th Congress), Permanent Internet Tax Freedom Act of 2013, sponsored by Sen. Ayotte)
b. Place a moratorium of, for example, 5 years on new state and local taxes on wireless services (such as taxes on cell phone usage) that are not imposed on other products or services (S.543 (112th Congress), Wireless Tax Fairness Act of 2011, sponsored by Sen. Wyden)
c. Expand the federally-created safe-harbor governing how much activity a business must engage in within a state to become subject to that state's business activity taxes (such as taxes on corporate profits) (H.R.1439 (112th Congress), Business Activity Tax Simplification Act, sponsored by Reps. Goodlatte and Scott)
d. Prohibit discriminatory state taxes on motor vehicle rentals (H.R.2469 (112th Congress), End Discriminatory State Taxes for Automobile Renters Act of 2011, sponsored by Rep. Cohen)
e. Prohibit state or local governments from imposing occupancy taxes on booking fees of online travel companies (Tax Foundation, "Cities Pursue Discriminatory Taxation of Online Travel Services," 2010)

ECONOMIC SECURITY: HEALTH, RETIREMENT, LIFE INSURANCE, FRINGE BENEFITS AND EXECUTIVE COMPENSATION

Senate Finance Committee Staff Tax Reform Options for Discussion

May 23, 2013

This document is the seventh in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The tax code plays an important role in individual economic security. It encourages retirement savings and facilitates access to affordable health insurance through employer-sponsored arrangements. Tax reform provides an opportunity to review all of these rules, determine which are achieving the desired goals, and which are creating economic or behavioral distortions that should be changed.

Following are several potential goals that could serve as guidelines for the Committee when reviewing the tax rules that affect the economic security of Americans:

- Minimize the disruption to business practices and employee expectations inherent in any fundamental tax reform
- Simplify the taxation of retirement savings and health insurance
- Increase the number of people with enough resources for an adequate standard of living in retirement, and expand access to health insurance
- Maximize the bang-for-the-buck of any tax incentives that are retained or reformed
- Develop neutral rules regarding compensation and fringe benefits to ensure that business needs and not tax planning drive compensation decisions, while minimizing compliance costs

Some specific concerns related to the tax rules associated with individual economic security include the following:

- **Complexity**: There are a host of provisions related to employee benefits in the tax code. For example, there are at least five different types of tax-preferred, defined contribution retirement plans in addition to defined benefit plans and individual retirement accounts (IRAs). While each has different features and requirements, employers and plan administrators are often able to simplify the process for employees. Nonetheless, there is plenty of room for improvement in making it easier for employers to choose among and administer these plans, and easier for employees to participate.

- **Low bang-for-the-buck for tax incentives:** Tax incentives in this area could potentially achieve more at a lower cost. For example, only 54% of all workers (excluding federal employees) and 65% of all such full-time workers participate in an employer-sponsored retirement plan according to the Bureau of Labor Statistics. Research has found that if employers automatically enroll new employees in a retirement savings plan unless the employee opts out, the percentage of workers who participate in the plan increases substantially, both in the short term and over time. The Pension Protection Act of 2006 encouraged more employers to adopt automatic enrollment but many still have not. Tax reform could also consider whether tax-preferred life insurance products are actually being used for insurance purposes.

- **Executive compensation**: Some believe that the rapid increase in some forms of executive compensation is, at least in part, attributable to our tax laws. According to a recent Bloomberg report, the CEOs of the S&P 500 Index top 250 companies received, on average, more than 200 times more in compensation than their rank-and-file workers, according to the most recent data. In 1950, this ratio was 42-1 instead. The current limit on corporate deductions for compensation in excess of $1 million may have

had the unintended consequence of encouraging companies to award large equity compensation grants. Furthermore, many commentators believe that golden parachute agreements actually increased in number after Congress passed laws intended to curb such agreements. Others believe executive compensation is driven by market forces. They note that highly-compensated employees who are not subject to the aforementioned limit on compensation deductions, such as professional athletes, musicians and actors, have also experienced significant growth in compensation. For instance, according to the Baseball Almanac, major league baseball players' annual compensation has risen from an average of $30,000 in 1970 to $3.3 million in 2010.

REFORM OPTIONS

I. RETIREMENT

Under current law, individuals have three sources of savings for retirement. The first is Social Security. The second is employer-sponsored savings vehicles, which are sometimes called "qualified retirement plans." These plans include both defined benefit plans and defined contribution plans, such as 401(k) plans. The third is individual savings, including tax-preferred savings vehicles such as IRAs and annuity contracts.

The tax benefits for retirement savings are one of the largest of all individual tax expenditures. Under current tax law, contributions to "traditional" defined contribution plans and IRAs benefit from "deferral." Such contributions are either excluded from the employee's income or deductible to the employee. As a result, the contributions are made out of pre-tax dollars. The employee is then not taxed on either the contributions or the earnings on the contributions until a distribution takes place. In contrast, contributions to Roth defined contribution plans and Roth IRAs are made with after-tax dollars and no tax applies to the earnings thereafter. The tax rules also apply penalties for early withdrawals from defined contribution plans to prevent leakage.

Additional incentives exist to encourage individuals who are otherwise underserved in the employer-sponsored market, generally those with lower incomes, to save for retirement. For example, the saver's credit is available for low income individuals that contribute to retirement plans, including IRAs and 401(k) plans. Employers are also encouraged to start up and maintain plans through certain tax incentives and simplification measures.

There are a number of rules regarding how defined contribution and defined benefit plans must be established and administered in both the tax law and the Employee Retirement Income Security Act (ERISA). These rules limit tax preferences to a certain amount of contributions and to retirement plans that do not discriminate in favor of highly-compensated employees. These rules also limit or penalize pre-retirement withdrawals by employees from retirement plans. Employer-sponsored defined benefit and defined contribution plans are regulated by both the Department of Labor and the Treasury Department. Other, non-qualified plans, such as IRAs and private annuity contracts are not subject to ERISA and are not regulated by the Department of Labor.

1. Limit or eliminate tax preferences for retirement saving

a. Significantly reduce or repeal all tax expenditures for retirement savings and replace with automatic enrollment or expanded Social Security benefits (Farrell, "To Boost Retirement Savings, Stop Giving Tax Breaks on 401(k)s," Bloomberg, April 2013; New America Foundation, "Expanded Social Security, A Plan to Increase Retirement Security for All Americans," April 2013; Kwak, "Washington's Backward Retirement Policy: So Wrong, and Yet So Easy to Fix," The Atlantic, April 2013)

b. Reduce limits on tax-preferred contributions to retirement plans to, for example, $14,850 for defined contribution plans and $4,500 for individual retirement accounts (IRAs), or to a percentage of taxpayer's income (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011; estimated in 2011 to raise $46 billion over 10 years; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010; Bipartisan Policy Center, "Restoring America's Future," November 2010)

   i. Alternatively, could temporarily or permanently repeal inflation indexing for limits on tax-preferred contributions

c. Cap the value of deductions and exclusions for defined contribution plans to 28 cents per dollar contributed (FY2014 Administration Budget Proposal)

d. Disallow further tax-preferred contributions to defined contribution or defined benefit plans once the total value reaches the equivalent of, for example, $3 million or roughly $200,000 annual annuity at today's interest rates (FY2014 Administration Budget Proposal; estimated in 2013 to raise $5 billion over 10 years)

e. Eliminate higher "catch up" contributions limits for those age 50 years or older (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011)

f. Require inherited IRAs to be distributed within five years (with exceptions for a beneficiary within 10 years of the account holder's age, individuals who are disabled or with special needs, a minor, or the IRA holder's spouse) (FY2014 Administration Budget Proposal; estimated in 2013 to raise $5 billion over 10 years; Modifications to Chairman's Mark of the Moving Ahead for Progress in the 21st Century Act, H.R.4348 (112th Congress); Sen. Cardin, Retirement Adequacy, Access, and Clarification Act Summary, 2013)

g. Repeal deduction for dividends paid by C corporations to employee stock ownership plans (FY2014 Administration Budget Proposal; estimated in 2013 to raise $8 billion over 10 years)

h. Repeal non-deductible IRAs (Joint Committee on Taxation, "Study Of The Overall State Of The Federal Tax System And Recommendations For Simplification," March 2001)

2. Replace deductions, exclusions and credits for retirement savings with a single refundable tax credit

a. Replace current exclusions, deductions and credits for defined contribution plans and IRAs with a refundable credit matching, for example, 33% of retirement savings that is directly deposited into the account (Testimony of Dr. William Gale before the Finance Committee, September 15, 2011; AARP, "New Ways to Promote Retirement Saving," October 2012; Center for American Progress, "Budgeting for Growth and Prosperity," May 2011)

   i. Could replace income tax deductions and exclusions only, or could also replace payroll tax exclusions

   ii. Could repeal deduction for contributions and exclusion for Roth earnings, but not deferral of tax on accrued earnings

   iii. Could limit annual per-person contributions to, for example, $15,000 or 15% of income

3. Increase retirement savings incentives

a. Expand the saver's tax credit and make it refundable (Testimony of Karen Friedman before the Finance Committee, September 15, 2011; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010; Bipartisan Policy Center, "Restoring America's Future," November 2010; FY2011 Administration Budget Proposal; estimated in 2010 to raise $10 billion over 10 years; H.R.837, (113th Congress), Savings for American

Families' Future Act of 2013, sponsored by Rep. Neal and others; The Hamilton Project, "Better Ways to Promote Saving through the Tax System," February 2013)

   i. Could also double the credit if the taxpayer elects to have it deposited directly into their retirement account

b. Expand the credit for small employer pension plan startup costs from $500 to, for example, $1,000 (S.1557 (112th Congress), Automatic IRA Act of 2011, sponsored by Sens. Bingaman and Kerry; H.R.4050 (112th Congress), Retirement Plan Simplification and Enhancement Act of 2012, sponsored by Rep. Neal)

c. In connection with replacing existing income tax with a flat tax, repeal non-discrimination rules, contribution limits, and restrictions on distributions (S.173 (113th Congress), Simplified, Manageable, And Responsible Tax Act, sponsored by Sen. Shelby)

4. Attempt to increase effect of tax expenditures for retirement savings on retirement security

a. Increase automatic retirement savings vehicles

   i. Require employers that do not sponsor a qualified retirement plan to automatically enroll their workers in IRAs if, for example, the employer has more than 10 employees (FY2014 Administration Budget Proposal; estimated in 2013 to cost $11 billion over 10 years; S.1557 (112th Congress), Automatic IRA Act of 2011, sponsored by Sens. Bingaman and Kerry; H.R.4049 (112th Congress), Automatic IRA Act of 2012, sponsored by Reps. Neal and Blumenauer; The Hamilton Project, "Better Ways to Promote Saving through the Tax System," February 2013; Sen. Harkin, "The Retirement Crisis and a Plan to Solve It," U.S. Senate Committee on Health, Education, Labor, and Pensions, July 2012; Urban Institute Opportunity and Ownership Project, "Why Not a 'Super Simple' Savings Plan for the United States?" May 2008)

      1. Could provide a credit to such employers for automatically enrolling their workers in IRAs rather than imposing a fee if they do not
      2. Could also require employer to make a contribution or government could make matching contributions for low and moderate income workers
      3. Could require that IRA provide a lifetime income benefit

ii. Revise automatic enrollment safe harbor for retirement plans to encourage more savings (H.R.4050 (112th Congress), Retirement Plan Simplification and Enhancement Act of 2012, sponsored by Rep. Neal; H.R.1534 (112th Congress) SAVE Act, sponsored by Reps. Kind and Reichert)

b. Increase the use of retirement savings to purchase life annuities or long-term care insurance

i. Provide incentives for or require taxpayers to use a portion of tax-preferred retirement savings to purchase life annuities or long-term care insurance by, for example, providing an exclusion for a portion of distributions from retirement plans if the funds were used to purchase a life annuity (Testimony of Karen Friedman before the Finance Committee, September 15, 2011; Sen. Cardin, Retirement Adequacy, Access and Clarification Act Summary, 2013; H.R.2748 (111th Congress), Retirement Security Needs Lifetime Pay Act of 2009, sponsored by Reps. Pomeroy and Brown-Waite)

ii. Automatically distribute defined contribution funds as life annuities at retirement unless accountholder opts out (Brookings Institution, "Increasing Annuitization in 401(k) Plans with Automatic Trial Income," June, 2008)

c. Expand the defined contribution rules for long-term, part-time workers by, for example, requiring employers maintaining a 401(k) plan to allow certain part-time employees to access the plan (S.1288 (110th Congress), Women's Retirement Security Act of 2007, sponsored by Sen. Smith and others)

d. Require disclosure of total benefits accrued under a defined contribution plan as the equivalent monthly annuity payment the participant or beneficiary would receive (S.267 (112th Congress), Lifetime Income Disclosure Act, sponsored by Sens. Bingaman, Isakson, and Kohl)

5. Simplify process of selecting and administering a plan for employers

a. Consolidate existing plan options for employers

i. Establish the "Save at Work" plan to combine all current employer-provided arrangements into a single plan with a single set of administrative rules. (President's Advisory Panel on Federal Tax Reform, 2005)

ii. Consolidate retirement accounts (The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010; Bipartisan Policy Center, "Restoring America's Future," November 2010)
iii. Consolidate traditional and Roth IRAs into a new tax-preferred lifetime retirement savings account (S.3018 (111th Congress), Bipartisan Tax Fairness and Simplification Act of 2010, sponsored by Sen. Wyden and others)

b. Simplify and reduce the administrative burden on plan sponsors by, for example, reducing and streamlining the number of required notices, and updating rules to better accommodate electronic delivery of notices (American Benefits Council, "Statement to the U.S. House of Representatives Committee on Ways and Means Pension/Retirement Tax Reform Working Group," April 2013)

6. Establish new plan options for employers

a. Create multiple small employer plans (MSEPs) (H.R.1534 (112th Congress) SAVE Act, sponsored by Reps. Kind and Reichert)

7. Reduce "leakage" from retirement plans

a. Prohibit individuals from withdrawing some portion of funds in defined contribution plans and IRAs prior to retirement (Testimony of Karen Friedman before the Finance Committee, September 15, 2011)
b. Modify the existing rules regarding rollovers and withdrawals to reduce leakage (S.606 (113th Congress), Shrinking Emergency Account Losses Act, sponsored by Sens. Nelson and Enzi)
   i. Extend time to rollover loan offset amount until due date of tax return
   ii. Extend the rollover period for defined contribution plan loan amounts outstanding when employment is terminated
   iii. Allow plan participants to continue to make elective contributions to a qualified plan during the six months following a hardship withdrawal
   iv. Ban the 401(k) debit or credit card

8. Allow more flexibility in distributions from retirement savings accounts

a. Allow taxpayers to withdraw money from a qualified retirement account penalty-free to make mortgage payments toward a primary residence (S.1656 (112th Congress), Hardship Outlays to protect Mortgage Equity Act of 2011, sponsored by Sen. Isakson)
b. Relax distribution limits for SIMPLE IRA plans and change contribution limits to resemble those of 401(k) plans (H.R.1534 (112th Congress) SAVE Act, sponsored by Reps. Kind and Reichert)
c. Eliminate the minimum distribution rules for individuals and couples whose vested interests in tax-qualified plans are less than, for example, $100,000 (American Bar Association, Section on Taxation, "Options for Tax Reform Regarding Employee Benefits and Executive Compensation," October 2012)
d. Allow penalty-free withdrawals from IRAs of up to, for example, $10,000 if used to pay adoption expenses, and unlimited withdrawals for expenses related to adopting a special needs child (H.R.1476 (113th Congress), Dave Thomas Adoption Act of 2013, sponsored by Rep. King and others)
e. Adjust rules relating to spousal access to retirement benefits, for example by allowing a participant and current spouse to lock into a deferred life annuity as part of a qualified domestic relations order (American Bar Association, Section on Taxation, "Options for Tax Reform Regarding Employee Benefits and Executive Compensation," October 2012)

9. Other long-term savings vehicles

a. Establish "Lifetime Savings Account" for each child born in the U.S. starting with a federal government contribution of, for example, $500 (S.3577 (111th Congress), America Saving for Personal Investment, Retirement and Education Act of 2010, sponsored by Sens. Schumer and Dodd)
b. Expand section 529 to give individuals with disabilities and/or their families access to tax-preferred savings (S.313 (113th Congress) Achieving a Better Life Experience Act of 2013, sponsored by Sen. Casey, Burr, Rockefeller, Roberts, Schumer, Stabenow, Cardin, and others)

II. HEALTH

Under current law, individuals who receive health insurance through their employer do not include the cost of their health insurance in income. These individuals are also able to deduct amounts they pay for health insurance premiums and funds they transfer to health accounts. The exclusion from income of employer-sponsored health insurance is the single largest tax expenditure in the tax code.

Individuals may deduct medical and dental expenses that are greater than 10% of their adjusted gross income. Premiums, including those for Medicare, qualify as a medical expense. In addition, starting in 2014, some individuals will be eligible for the refundable health insurance premium tax credits to help purchase health insurance through the new health insurance Exchanges.

Individuals may also take advantage of medical spending accounts to accumulate money for health expenses on a tax-preferred basis. Contributions to Flexible Spending Accounts (FSAs) and Health Savings Accounts (HSAs) are deductible and, as along as the monies are used for qualified medical expenses, no tax is ever collected on the money deposited in the accounts. The annual cap on individual contributions to FSAs is $2,500. Each year, FSAs are reset to zero and any unused money is lost by the individual. For 2013, HSA contributions are capped at $3,250 for an individual and $6,450 for a family. HSAs can only be established in connection with a high-deductible health plan.

1. Reduce tax expenditures for employer-provided health benefits

a. Repeal tax incentives for employer-provided health benefits
   i. Repeal the exclusion for employer-provided health benefits by imposing a cap which decreases over time until all employer contributions are subject to tax (Bipartisan Policy Center, "Restoring America's Future," November 2010; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010)
   ii. Disallow new contributions to health savings accounts and flexible spending accounts (Bipartisan Policy Center, "Restoring America's Future," November 2010; Center for American Progress, "Budgeting for Growth and Prosperity," May 2011)

b. Limit the employer-provided health insurance exclusion to the average cost of health coverage and either (President's Advisory Panel on Federal Tax Reform, 2005):

i. Allow a deduction for the purchase of health insurance in the individual market up to the average cost for health insurance, or
ii. Provide a deduction equal to the exclusion for employer-provided insurance for workers without employer-provided plans

2. Modify the Affordable Care Act (ACA)

a. Refine certain provisions of ACA
   i. Make certain over-the-counter drugs payable through a health savings account or flexible spending account and repeal the provider's prescription requirement (H.R.4224 (112th Congress), Offering Patients True Individualized Options Now Act of 2012, sponsored by Rep. Broun)
   ii. Accelerate the excise tax on high-premium health insurance plans (Goldsmith, "Letting Go of Employer-Based Health Insurance," Health Affairs Blog, July 2011)
   iii. Reduce the excise tax on high-premium health insurance plans in conjunction with reducing the exclusion for employer-sponsored health insurance to, for example, the 80th percentile for single and family employer-sponsored premiums (Bipartisan Policy Center, "A Bipartisan Rx for Patient-Centered Care and System-wide Cost Containment," April 2013; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010)
   iv. Replace the medical device fee with a fee on the medical device industry structured similarly to the pharmaceutical and health insurance fees (S.1796 (111th Congress), America's Healthy Futures Act of 2009, sponsored by Sen. Baucus)
      1. Create an exemption for small domestic manufacturers
   v. Replace the annual fee on health insurance providers with a tax on all paid health insurance claims (Bipartisan Policy Center, "A Bipartisan Rx for Patient-Centered Care and System-wide Cost Containment," April 2013)
      1. Would apply to claims paid by a commercially-insured plan or a third-party administrator working on behalf of a self-insured employer
   vi. Extend the requirement that employers provide minimum essential health insurance coverage to part-time employees (H.R.675 (113th Congress), Part-Time Worker Bill of Rights Act of 2013, sponsored by Rep. Schakowsky and others)

vii. Ease the burden on employers by, for example, modifying reporting requirements and the definitions of full-time employee and large employers (National Association of Health Underwriters, Employers for Flexibility in Health Care Coalition, April 2013)

b. Repeal certain provisions of the ACA
   i. Repeal the shared responsibility for employers regarding health coverage (S.399 (113th Congress), American Job Protection Act, sponsored by Sen. Hatch and others)
   ii. Repeal the requirement that individuals maintain minimum essential coverage (section 1501 of ACA) (S.12 (112th Congress), Job Creation Act of 2011, sponsored by Sen. Portman)
   iii. Repeal the medical device tax (S.232 (113th Congress), Medical Device Access and Innovation Protection Act, sponsored by Sens. Hatch, Klobuchar, Crapo, Casey, Roberts, Enzi, Cornyn, Thune, Isakson, Portman, Toomey, and others)

c. Replace the employer-provided health insurance exclusion with a refundable or non-refundable tax credit for employer-provided health insurance (Roosevelt Institute Campus Network, "Budget for a Millennial America," May 2011)
   i. Alternatively, replace the premium assistance credit as well and allow the new credit for both employer-provided health insurance and health insurance purchased through the exchanges (Peter G. Petersen Foundation, "The 2011 Fiscal Summit: The Solutions Initiative," May 2011)

3. Expand the tax benefits for health

a. Expand health savings accounts (S.1098 (112th Congress), Family and Retirement Health Investment Act of 2011, sponsored by Sens. Hatch, Inhofe and others)

b. Repeal the $2,500 annual cap for health flexible spending arrangements under cafeteria plans (S.24 (113th Congress), Small Business Health Relief Act of 2013, sponsored by Sen. Portman)

c. Allow the self-employed to deduct health insurance premiums for purposes of self-employment taxes (H.R.886 (113th Congress), America's Small Business Tax Relief Act of 2013, sponsored by Reps. Gerlack and Kind)

d. Repeal the floor on deducting medical expenses for individuals under age 65 who have no employer health coverage (H.R.99 (112th Congress), The Fair and Simple Tax Act of 2011, sponsored by Reps. Drier, Ross, and Sessions)

e. Exclude from an employee's income the fees paid by an employer to an athletic or fitness facility on the employee's behalf (S.39 (113th Congress), Healthy Lifestyles and Prevention America Act, sponsored by Sen. Harkin)
f. Harmonize treatment of local and state government employees when passing on tax-preferred health accounts to non-dependents (S.1366 (112th Congress), A bill to broaden the special rules… to include plans established by political subdivisions, sponsored by Sens. Cantwell, Crapo and others)

4. **Expand long-term care benefits** (The Jerome Levy Economics Institute, "Financing Long-Term Care: Options for Policy," January 2000)

a. Subsidize the purchase of long-term care insurance through an income tax credit or tax deduction for premiums
b. Require individuals to carry long-term care insurance and provide a refundable tax credit for purchase

5. **Reform excise taxes and other tax provisions that may affect health**

a. Increase tobacco taxes (FY2014 Administration Budget Proposal; S.826 (113th Congress), Tobacco Tax and Enforcement Reform Act, sponsored by Sen. Lautenberg and others; Robert Wood Johnson Foundation, "The Impact of Tax and Smoke-Free Air Policy Changes," April 2011)
   i. Establish parity in the tax rate between all types of tobacco including smokeless, roll-your-own, and pipe tobacco
   ii. Require electronic tax stamps on every package of tobacco product to address smuggling and evasion
   iii. Provide a tax credit to help defray costs of use of tobacco cessation products and services (H.R.2876 (108th Congress), The Quit Smoking Incentive and Opportunity Act of 2003, sponsored by Rep. LaTourette and others)
b. Modify alcohol taxes
   i. Increase alcohol taxes (Minnesota H.F. 677 (88th Legislature), Omnibus Tax Bill, sponsored by state Rep. Lenczewski)
   ii. Establish a uniform tax rate based on the alcohol content of the product (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

iii. Reduce the excise tax rate on beer to pre-1991 levels (S.958, (113th Congress), the "Brewers Excise and Economic Relief "BEER" Act of 2013," sponsored by Sens. Udall, Bennet, and others)
iv. Reduce the excise tax rate on small production brewers (S.917 (113th Congress), Small Brewer Reinvestment and Expanding Workforce Act of 2013, sponsored by Sens. Cardin, Bennet, Carper, Menendez, Portman, Schumer, Wyden, and others)

c. Institute a tax on recreational marijuana use (Colorado H.B.1318 (69th General Assembly), A Bill … Implementing Certain State Taxes on Retail Marijuana, sponsored by state Rep. Singer)
d. Impose an excise tax on sales of sugary beverages (Wang et al., "A Penny-Per-Ounce Tax on Sugar-Sweetened Beverages Would Cut Health and Cost Burdens of Diabetes," Health Affairs, January 2012; New England Alliance for Children's Health, "Sugar-Sweetened Beverage Tax Policy Brief," October 2010; Yale University Rudd Center, "Soft Drink Taxes Policy Brief," Fall 2009)
e. Modify other tax provisions
    i. Deny deductions for the cost of direct-to-consumer advertising for prescription drugs (H.R.923, (113th Congress), Say No to Drug Ads Act, sponsored by Rep. Nadler)
    ii. Deny deductions for advertising and marketing expenses primarily directed at children that promote food of poor nutritional quality (H.R.6599 (112th Congress), Stop Subsidizing Childhood Obesity Act, sponsored by Rep. Kucinich and others; Institute of Medicine, "Food Marketing to Children and Youth," 2006)

III. LIFE INSURANCE AND ANNUITIES

Under current law, earnings that accrue on cash values of life insurance policies and annuity contracts are not taxed until they are distributed. Further, death benefits paid from a life insurance contract are excluded from the beneficiary's income, and if there has been no prior distribution of the accrued earnings those earnings are never taxed. Employers may also currently provide up to $50,000 in group term life insurance to their employees without the employees including the value of that coverage in their income. If the owner of a life insurance contract cashes out the contract prior to the insured's death, current IRS rulings require that the gain on the contract be increased by the value of the insurance coverage to date (called the "cost of insurance"), although that value is undefined.

1. **Reduce tax expenditures for life insurance products**

    a. Currently tax the annual increase in the inside build-up on life insurance contracts (Center for American Progress, "Budgeting for Growth and Prosperity," May 2011)
    b. Deny exclusion for death benefit payments above a specified amount (Geier, "The Taxation of Income Available for Discretionary Use," Virginia Tax Review, April 2006)

2. **Reduce tax expenditures for annuities**

    a. Currently tax the annual increase in the inside build-up on annuity contracts (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011; estimated in 2011 to raise $260 billion over 10 years)

3. **Other**

    a. Expand pro rata interest expense disallowance for corporate-owned life insurance (COLI) (FY2014 Administration Budget Proposal; estimated in 2013 to raise $7 billion over 10 years)
    b. Clarify impact of cost of insurance on the investor's gain (S.2048 (112th Congress), A bill to … clarify the tax treatment of certain life insurance contract transactions …, sponsored by Sen. Casey)
    c. Increase the $50,000 limit for employer-provided group term life insurance (H.R.1618 (113th Congress), A bill to … to increase the dollar limitation on employer-provided group term life insurance that can be excluded from the gross income of the employee, sponsored by Rep. Burgess)

IV. OTHER EMPLOYEE FRINGE BENEFITS

The tax law provides for numerous employer-provided fringe benefits that are either partially or completely non-taxable to employees. In some cases, these exclusions are for administrative convenience; in others, they are to promote various policies, such as supporting education.

1. Limit exclusions for other employee fringe benefits

a. Impose a 50% tax on employers for the net cost of meals, entertainment, gyms, and dining facilities provided to employees and customers, unless the cost is included in the employee's income and reflected on their Form W-2 (Johnson, "An Employer-level Proxy Tax on Fringe Benefits," Tax Notes, April 2009)
b. Repeal or reduce the exclusion for employer reimbursement of parking expenses to, for example, $100 (Center for American Progress, "Budgeting for Growth and Prosperity," May 2011; Mann, "On the Road Again: How Tax Policy Drives Transportation," Virginia Tax Review, 2005)
c. Repeal exclusion for certain employee achievement awards (S.3018 (111th Congress), The Bipartisan Tax Fairness and Simplification Act of 2010, sponsored by Sens. Wyden, Gregg, and others)
d. Increase the amount of taxable income that an employee or executive must report for the personal use of a corporate jet to better reflect the economic value of such benefit by (S.2031 (109th Congress), A bill to provide for the valuation of employee personal use of noncommercial aircraft for purposes of Federal income tax inclusion, sponsored by Sen. Dayton)
    i. Increasing the existing Standard Industry Fare Level (SIFL) rates used to compute taxable income based on an IRS formula for determining what a first-class seat on a comparable commercial flight would have cost
    ii. Using the proxy rules, or
    iii. By using the actual costs of operating the jet
e. Repeal or modify exclusions for housing, for example for clergy, university employees or nonprofit executives (Reilly, "Cash Parsonage Allowances - Constitutional But Bad Tax Policy - Law Professor Argues," Forbes, March 2012; Aprill, "Parsonage and Tax Policy: Rethinking the Exclusion", Loyola Law School, Los Angeles, June, 2010; Flynn and Strom, Plum Benefit to Cultural Post: Tax-Free Housing, New York Times, August 9, 2010)

2. Expand tax preferences for other employee fringe benefits

a. Allow employees to exclude up to, for example, $5,000 in payments by employer under a student loan repayment assistance program (H.R.395 (113th Congress), Student Loan Employment Benefits Act of 2013, sponsored by Rep. Israel and others)

b. Allow employees to exclude up to, for example, $600 in employer contributions to a qualified tuition program (H.R.529 (113th Congress), Savings Enhancement for Education in College Act, sponsored by Reps. Jenkins and Kind)
c. Permit election to include award plans for bona fide safety service volunteers based upon the volunteer's length of service to be treated as deferred compensation (H.R.1009 (113th Congress), Volunteer Emergency Services Recruitment and Retention Act, sponsored by Rep. King and others)

3. Harmonize employee fringe benefit rules

a. Equalize exclusion for employer-paid parking and transportation benefits (Tax Foundation, "Income Tax Code No Longer Favors Parking over Transit... For Now," January 2013)

V. EXECUTIVE COMPENSATION

Executive compensation generally refers to compensation of the members of the senior management team. Some forms of executive compensation include salaries, short term incentive pay (such as bonuses), long-term incentive pay (such as stock awards) and option awards, extra benefits (such as club memberships), and deferred compensation. The tax treatment of the various components of executive compensation varies depending on the specific item of compensation.

1. Revise the limits on the deductibility of executive compensation

Businesses can deduct the cost of reasonable compensation paid to employees. However, Section 162(m) limits the deduction for compensation to $1 million for the top four executives of public companies, with an exception for certain performance-based compensation, which includes stock options. (Special, more restrictive rules apply to companies that have received government bailout funds and certain health insurance companies.) In many cases, companies are able to plan around the limits of Section 162(m) through the use of performance-based compensation.

a. Repeal the Section 162(m) limitation (Joint Committee on Taxation, "Report Of Investigation Of Enron Corporation And Related Entities Regarding Federal Tax And Compensation Issues, And Policy Recommendations," February 2013;

Congressional Research Service, "The Economics of Corporate Executive Pay," December 2007)

b. Modify the definition of covered employee for purposes of Section 162(m) to expand the limitation on deductibility of compensation to a larger group of executives (S.349 (110th Congress), Small Business and Work Opportunity Act of 2007, sponsored by Sen. Baucus)
c. Apply the Section 162(m) limitation to all equity compensation, including stock options (S.268 (113th Congress), CUT Loopholes Act, sponsored by Sens. Levin and Whitehouse)
d. Cap deduction for total executive compensation at multiple of (e.g., 25 times) the lowest compensation paid to any other employee or a set dollar amount (e.g., $500,000), whichever is lower (H.R.199 (113th Congress) Income Equity Act of 2013, sponsored by Reps. Lee, Ellison, and Schakowsky)

2. Revise the rules related to non-qualified deferred compensation

Deferred compensation is compensation that an employee earns in one period but will not receive until a future period. Many deferred compensation plans are "qualified plans," such as 401(k)s, which were discussed in Part I. In order to be a qualified plan, these plans must meet a number of requirements, such as limiting contributions to a certain amount and not discriminating in favor of highly-compensated employees. Non-qualified plans are simply deferred compensation arrangements that do not meet these requirements.

Employees are generally not taxed on non-qualified deferred compensation as long as there is a risk that the employee will not receive the compensation. For example, if the employee will not receive the deferred compensation if he leaves the company within five years, he will not be taxed on the compensation until the end of that five year period. Under a nonqualified deferred compensation plan, the employer's deduction is deferred until the employee has income.

There is, however, an exception to these rules for non-qualified deferred compensation plans that do not comply with various rules regarding the timing of deferrals and distributions under Section 409A. The penalty for non-compliance with the 409A requirements is that all amounts deferred under the plan to date are immediately taxed and subject to a 20% penalty tax, with interest.

a. Modify or repeal Section 409A (Polsky, "Fixing Section 409A: Legislative and Administrative Options," Villanova Law Review, 2012)
   i. Repeal Section 409A and replace with rules (or authority to Treasury to promulgate rules) that tax the value of deferred compensation when it is effectively received
   ii. Repeal Section 409A for employees of private companies
   iii. Repeal the 20% penalty tax
b. Tax employees on non-qualified deferred compensation (and earnings on such compensation) in the year it is earned (i.e., repeal deferral) (Doran," Time to Start Over on Deferred Compensation," Virginia Tax Review, 2008)
   i. Alternatively, require employers to pay a special tax on the investment earnings attributable to non-qualified deferred compensation (Halperin and Yale, "Deferred Compensation Revisited," Tax Notes, February 2007)
   ii. Alternatively, provide a default rule that requires executives to pay tax on the earnings on non-qualified deferred compensation, but allow companies to elect to pay a special tax on the investment income attributable to the deferred compensation in lieu of the executive (Urban Brookings Tax Policy Center, "Executive Compensation Reform and the Limits of Tax Policy," November 2004)
c. Impose a $1 million limit on non-qualified deferred compensation that can be deferred in a single year (S.2866 (110th Congress), Corporate Executive Compensation Accountability and Transparency Act, sponsored by Sen. Clinton)

3. Revise the rules related to equity-based compensation

The taxation of equity-based compensation varies depending on the type of equity, such as stock options or restricted stock, and the conditions associated with its transfer to the employee. For tax purposes, stock options are classified as either non-statutory stock options or statutory stock options (including 'incentive stock options'). Employees are taxed on non-statutory stock options when the options are exercised. The amount of income the employee must pay tax on is the fair market value of the stock less the exercise price. The employer can deduct a corresponding amount at the same time.

In contrast, employees are generally taxed on incentive stock options when the employee sells the underlying shares after exercising the options. For incentive stock options, the employee is generally taxed at ordinary rates if the employee did not meet certain holding period requirements and at capital gain rates if the holding period requirements were met. The employer generally only can deduct the value of incentive

stock options if the holding period requirements are not met. The alternative minimum tax neutralizes the tax benefits of incentive stock options in many cases.

Other types of equity-based compensation, such as restricted stock, are generally taxable when the employee's ownership of the equity has vested, and the corporation can take a corresponding deduction at the same time. The amount of income that the employee must pay tax on (and the employer's corresponding deduction) are measured based upon the fair market value of the stock at the time of vesting less the amount, if anything, that the employee paid for the stock.

a. Repeal incentive stock options (Treasury Department, "Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984)
b. Modify the tax deductibility of stock options (S.268 (113th Congress), CUT Loopholes Act, sponsored by Sens. Levin and Whitehouse):
    i. Limit the deduction for an employer to the value of the stock option as recorded on the employer's books at the time such options are granted
    ii. Require the employer to deduct the stock option in the year when it expenses the compensation on its books

4. Revise the rules related to golden parachute payments to executives upon a change in control

Under current tax law, if there is a change in control of a corporation, executives are required to pay a 20% excise tax on certain excess payments made that are contingent upon such change in control (sometimes called "parachute payments"). In addition, some portion of the company's tax deduction related to such payments may be disallowed.

a. Repeal limitations on employer's deducting excess parachute payments and repeal the excise tax on the employee for such payments (Ginsburg and Levin, Mergers, Acquisitions and Buyouts, February 2012; Lazar, "The Unreasonable Case for a Reasonable Compensation Standard in the Public Company Context," Buffalo Law Review, 2011)

FAMILIES, EDUCATION AND OPPORTUNITIES

Senate Finance Committee Staff Tax Reform Options for Discussion

April 18, 2013

This document is the third in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR TAX REFORM

The tax rules should be designed to equitably and efficiently collect revenue. In addition, while some disagree with this practice, the tax rules are often used to promote other policy objectives, such as incentivizing certain economic behavior that policymakers consider socially valuable.

The current tax code inherently affects decisions about whether to work, marry, have children, and pursue an education. It does so by deciding how to adjust tax burdens in light of these different circumstances. Tax reform provides an opportunity to rethink how and to what degree the tax code should reflect Americans' values regarding families, work, and education.

Following are some potential broad principles for reform in this area:

- Account for the costs of raising children in a manner that is equitable, efficient, simple, promotes opportunity, and takes spending programs into consideration
- Ensure that the tax code does not create large disincentives to work, taking into account tax rates, the phase-out of tax expenditures and means-tested transfer programs, and dependent care costs
- Carefully consider the existing tax incentives and disincentives to marry
- If the tax system includes education incentives, maximize their effect on educational attainment
- Carefully consider the implications of demographic trends
- Simplify the tax code and provide certainty by making temporary provisions permanent, eliminating them, or allowing them to expire

Some specific concerns about the taxation of families and education today include the following:

- **Complexity**: There are a large number of tax provisions related to children, work, and education. Many have different requirements and definitions, and some are temporary. This complexity and uncertainty results in confusion, unintended errors, large costs to taxpayers of complying with the tax code, and a weaker response to any tax provisions that policymakers intend to influence taxpayers' decisions.

- **Work disincentives:** The effective marginal tax rate at many income levels is sometimes surprisingly high because of various phase-outs (e.g., Earned Income Tax Credit, personal exemptions, child tax credit, Supplementary Nutrition Assistance Program, Temporary Assistance for Needy Families, and Medicaid) as well as the explicit statutory rates in the income and payroll taxes. A recent Congressional Budget Office (CBO) analysis found that some workers near the poverty line face effective marginal tax rates as high as 60%, and closer to 100% when one also considers phase-outs in the transfer system.

- **Work disincentives for primary caregivers and secondary earners:** Primary caregivers are adults with primary responsibility for caring for a dependent, such as a child or elderly parent. Some research suggests that primary caregivers have less of an incentive to work than others earning similar wages because of the cost of child and dependent care. According to the U.S. Census, in 2011, the average cost of full-time child care was about $7,400 per year, while median household income was $50,100. In addition, among married couples, joint filing and the graduated structure of the income tax

system reduce the incentive for the lower-paid spouse (sometimes called the "secondary earner") to work. This is because the lower-paid spouse's earnings are effectively taxed at a higher marginal rate because of the other spouse's earnings.

- **Marriage incentives and disincentives:** Marriage penalties and bonuses exist in the current tax code, meaning that, depending on their marital status, individuals may pay more or less income tax. As long as the tax code is progressive and married couples are taxed jointly rather than as individuals, there will be marriage penalties, marriage bonuses or both. According to the Congressional Research Service (CRS), roughly 20% of married couples pay a marriage penalty, while roughly 60% receive a marriage bonus.

- **Low bang-for-the-buck for tax incentives**: Some argue that tax incentives in this area, for example for higher education, could achieve more at a lower cost. For example, research by the CRS suggests that education tax incentives are smaller for those least likely to attend college. In addition, students often do not receive tax benefits for college until months (or even years, for example, in the case of the student loan interest deduction) after their tuition is due. The delay may result in education tax benefits having less impact on the decision of whether to attend or complete college than some would like.

- **Increasing cost of higher education:** Some are concerned that the existence of federal subsidies for education, including tax expenditures, drives up the cost of college and post-graduate education. According to Moody's, the cost of tuition and fees has more than doubled since 2000, outstripping the growth of real estate during the housing bubble.

- **Duplication with spending programs:** Some argue that the tax system should not subsidize the cost of children or education because direct spending programs can be more narrowly targeted and are more transparent. At a minimum, many believe that tax benefits and direct spending benefits should be more coordinated.

- **Fairness**: Some think that the tax code should do more to address increasing income disparities in the U.S. Others think the tax code is not a significant cause of increasing income disparities and should not be used to reduce these disparities as the tax code is already too progressive. Similarly, some think that the tax code should treat taxpayers raising children more favorably than it currently does compared to taxpayers who are not raising children. Others believe that the current tax code provides sufficient resources for the costs of raising children or should be revised to reduce or eliminate such tax benefits.

REFORM OPTIONS

I. CHILDREN AND WORK

The Internal Revenue Code currently provides several benefits to families related to the cost of raising children. These benefits may incentivize various behaviors within the family. The code contains an exemption for dependents, various credits for having or adopting children, and credits to assist with the cost of care for parents with employment-related expenses. The code also provides work incentives that are tied to not only work, but also the number of children in the household. The following table briefly summarizes these tax benefits.

Current Tax Provisions for Children and Work

Provision	Eligible income range	Maximum tax benefit in 2013
Child tax credit (CTC)	Refundable portion of credit available only to those with earnings above $3,000. Credit reduced by $50 for each $1,000 or portion thereof taxpayer's AGI exceeds $75,000 (single) or $110,000 (married filing jointly), not indexed for inflation.	$1,000 credit/child, (not indexed)
Earned income tax credit (EITC)	The credit amount begins to phase out at an income level of $17,530 ($7,970 for taxpayers with no qualifying children). These amounts are indexed. In 2018, the phase out threshold for joint returns will be reduced to its 2007 levels (indexed).	$6,044 for taxpayers with more than two qualifying children, $5,372 for taxpayers with two qualifying children, $3,250 for taxpayers with one qualifying child, and $487 for taxpayers with no qualifying children
Child and dependent care credit	Credit is reduced for taxpayers as AGI increases from $15,000 to $42,000, at which point it reaches its minimum level for all taxpayers, for a minimum benefit of $600/$1,200. (Not indexed)	$1,050 credit for one child or $2,100 credit for two or more children
Adoption credit	Non-refundable credit that phases out between $194,580 and $234,580	$12,970 credit
Dependent exemption	Exemptions phase out between $250,000 and $372,500 for single filers, and between $300,000 and $422,500 for joint filers	$3,900 deduction per qualifying child

Employer-provided child care exclusion	Available to all taxpayers, but exclusion may not exceed earnings	$5,000 exclusion from income (not indexed)
Head of household filing status	Available to single filers with dependents. For head of household filers, standard deduction and thresholds for rate brackets and income phase-outs are generally between those for single and joint filers. The tax brackets converge at the 35-percent bracket breakpoint, and diverge again at the 39.6-percent bracket breakpoint.	N/A

Note: Unless otherwise noted, all dollar amounts in table are inflation-adjusted.

1. **Eliminate all tax expenditures for children and work** (“Zero-Plan” in The National Commission on Fiscal Responsibility and Reform, “The Moment of Truth,” 2010; S.173 (113th Congress), the Simplified Manageable and Responsible Tax Act, sponsored by Sen. Shelby)

    a. Repeal all provisions listed in table above
    b. If members would like to maintain the current level of progressivity, a challenge with this option would be how to do so, given that these provisions are a significant source of progressivity in the tax code.

2. **Simplify tax provisions related to children and work through some or all of the following reforms**

    a. Make permanent the expansions to the EITC and CTC that are scheduled to expire in 2017 (FY14 Administration Budget Proposal, estimated to cost $68 billion over 10 years to extend from 2018-2023; S.A.4727 to H.R.4853 (111th Congress), The Middle Class Tax Cut Act of 2010, sponsored by Sen. Baucus; “Illustrative-Plan” in The National Commission on Fiscal Responsibility and Reform, “The Moment of Truth,” 2010)
    b. Simplify the EITC and reduce its error rate through the following reforms:
        i. Simplifying rules governing which parent can claim the EITC when parents are separated (President’s Economic Recovery Advisory Board (PERAB), “The Report on Tax Reform Options,” 2010)
        ii. Eliminating restriction for certain workers living with other peoples’ qualifying children (FY14 Administration Budget Proposal, estimated to cost $5.4 billion over 10 years; PERAB)
        iii. Simplifying or eliminating investment income test (PERAB)

c. Harmonize definitions across tax benefits by, for example, unifying the definition of a qualifying child or making the age of the child the only difference across tax benefits (Tax Policy Center (TPC), "Tax Simplification: Clarifying Work, Child, and Education Incentives," 2011)
d. Simplify head of household filing status by either:
    i. Simplifying requirements, for example, by eliminating household maintenance test for unmarried or estranged taxpayers with dependents who live apart on the last day of the year (PERAB; National Taxpayer Advocate, "Annual Report to Congress," 2012)
    ii. Repealing head of household filing status and increasing standard deduction for single parents (President's Advisory Panel on Tax Reform (PAPTR), "Final Report," 2005)
e. Harmonize or eliminate rules permitting divorced or separated parents to agree through legal settlement that non-custodial parent can claim child tax benefits (PERAB)
f. Index CTC amount (H.R.769 (113th Congress), Child Tax Credit Permanency Act of 2013, sponsored by Rep. DeLauro)

3. **Consolidate existing tax expenditures for children and work** (CBO, "Budget Options," 2003; American Enterprise Institute, "Moving Toward a Unified Credit for Low-Income Workers," 2009; PERAB; Brookings Institution, "Tax Reform for Families: An Earned Income Child Credit," 2003; PAPTR; Stein, "Taxes and the Family," 2010)

    a. Replace some or all of the following tax expenditures: EITC, CTC, dependent exemption, standard deduction, head of household filing status, child and dependent care credit, and exclusion for employer-provided child care with either:
        i. Single refundable tax credit for children and work
        ii. Two refundable credits—one for children and one for work
    b. Index credit amount and any income thresholds
    c. Design credit(s) to replicate distribution of existing tax benefits for children and work

4. **Simplify and better target tax benefits for child care through one or more of the following reforms**

    a. Improve existing child and dependent care credit by, for example:
        i. Making the child and dependent care credit fully refundable and indexing the parameters for inflation (S.56 (113th Congress), Right Start Child Care

and Education Act of 2013, sponsored by Sen. Boxer; Tax Policy Center (TPC), "Tax Subsidies to Help Low-Income Families Pay for Child Care," 2005)

   ii. Increasing the beginning of the phase down income threshold from $15,000 to, for example, $75,000 (FY14 Administration Budget Proposal, estimated to cost $9 billion over 10 years to extend from 2018-2023)

b. Allow a deduction for child and dependent care costs (Faulhaber, "How the IRS Hurts Mothers," 2013; deductions are available instead of credits in Idaho, Massachusetts, Montana and Virginia; both a credit and a deduction are in place in Maryland)

c. Repeal exclusion for employer-provided child care (Dept. of Treasury, "Tax Reform for Fairness, Simplicity, and Economic Growth," 1984)

5. Reduce work disincentives created by phase-outs of tax expenditures and means-tested transfer programs

a. Coordinate phase-outs of tax expenditures with each other and means-tested transfer programs to eliminate overwhelming implicit marginal tax rates (Urban Institute, "The Twice Poverty Trap," April 1995; Urban Institute, "Considerations in Efforts to Restructure Refundable Work-Based Credits," November 2009)

   i. Potential tax expenditures affected: EITC, CTC, personal exemption, health insurance affordability credits, adoption tax credit

   ii. Potential means-tested transfer programs affected: SNAP, TANF, CHIP, Medicaid

b. Eliminate phase-outs for many tax expenditures, such as the EITC, CTC, and personal exemption (Fred Goldberg testimony before the Finance Committee, 2005)

6. Other potential changes for targeted groups

a. Modify EITC for childless workers through one or more of the following reforms (Georgetown Center on Poverty, Inequality and Public Policy, "Expanding the EITC to Help More Low-Wage Workers," 2009; S.1333 (110th Congress), Strengthen the Earned Income Tax Credit Act of 2007, sponsored by Sen. Kerry; H.R.3970 (110th Congress), The Tax Reduction and Reform Act of 2007, sponsored by Rep. Rangel):

   i. Reduce age cut-off from 25 to 21

ii. Increase phase-in rate to 15.3% to fully offset payroll tax liability; increase income threshold at which phase-in ends so that a full-time minimum wage worker earns, for example, 150% of poverty line after tax

b. Make WOTC permanent (FY14 Administration Budget Proposal, estimated to cost $9 billion over 10 years) and potentially expand it (H.R.2101 (106th Congress), Work Opportunity Tax Credit Reform and Improvement Act of 1999, sponsored by Rep. Houghton)
   i. Could add in new targeted credits, such as credits for high poverty areas or caretakers reentering the labor force

c. Streamline WOTC employer certification requirement by, for example, allowing employers to certify employees as members of targeted groups in some circumstances (S.140 (113th Congress), Veteran Employment Transitions Act of 2013, sponsored by Sens. Baucus and Hatch; H.R.2082 (112th Congress), Work Opportunity Credit Improvements Act, sponsored by Rep. Schock)

d. Replace WOTC with payroll credit tied to unemployment rate
   i. Credit could be a percentage of increase in payroll over a base period (similar to proposal in FY14 Administration Budget Proposal, estimated to cost $26 billion over 10 years, and S.2237 (112th Congress), Small Business Jobs and Tax Relief Act, sponsored by Sen. Reid)

e. Create tax incentives for job training
   i. Establish allocable tax credit program to businesses that invest in apprenticeships or to encourage partnerships between businesses and colleges to provide job training (S.3466 (112th Congress), Better Education and Skills Training for America's Workforce Act, sponsored by Sen. Menendez; similar to Jobs Training Tax Credit in Rhode Island)
   ii. Create employer-matched, portable, employee-owned savings accounts to finance education and training (S.26 (110th Congress), Lifetime Learning Accounts Act, sponsored by Sens. Cantwell, Collins, Smith, and Snowe)

II. MARRIAGE

The federal income tax applies to all citizens and residents of the United States. Individual taxpayers file as single, head of household, married filing jointly or married filing separately. While married couples can file separate returns, the law is carefully structured so that filing separate returns almost always leads to a tax increase for couples compared to a joint return. Couples face a marriage penalty when they pay more income tax filing jointly than they would if

they were single. Conversely, a marriage bonus occurs if a couple pays less tax filing jointly than they would if they were single. For example, as shown in the table below, a single individual with $50,000 in taxable income is in the 25% marginal income tax bracket. If this individual marries a partner with no income, the new couple would face a 15% marginal income tax rate and would receive a marriage bonus.

Individual Income Tax Rates by Taxable Income, 2013

	Single	Head of Household	Married Filing Jointly
10%	$0 to $8,925	$0 to $12,750	$0 to $17,850
15%	$8,926 to $36,250	$12,751 to $48,600	$17,851 to $72,500
25%	$36,251 to $87,850	$48,601 to $125,450	$72,501 to $146,400
28%	$87,851 to $183,250	$125,451 to $203,150	$146,401 to $223,050
33%	$183,251 to $398,350	$203,151 to $398,350	$223,051 to $398,350
35%	$398,351 to $400,000	$398,351 to $425,000	$398,351 to $450,000
39.6%	Over $400,000	Over $425,000	Over $450,000

1. **Reduce marriage penalties and/or marriage bonuses for all** (following options are mutually exclusive)

    a. Eliminate marriage penalties (but create sizable marriage bonuses) through either of the following reforms:
        i. Make tax brackets and other income thresholds for married couples twice the amount for single filers (PAPTR)
        ii. Allow married couples to elect single filing where more favorable (S.1429 (106th Congress), Taxpayer Refund Act of 1999, sponsored by Sen. Roth)
    b. Eliminate marriage bonuses (but create sizable marriage penalties for some)
        i. Make tax brackets and other income thresholds for married couples identical to those for single filers (as was the law before 1948)
    c. Eliminate marriage penalties and bonuses and reduce work disincentives for secondary earners by:
        i. Repealing married filing jointly filing status (Alstott, "Updating the Welfare State: Marriage, the Income Tax, and Social Security in the Age of the New Individualism," 2013; CRS, "The Marriage Penalty and Other Family Tax Issues," 1998; also the practice in many other countries including Canada, Australia, Italy, and Japan)
            1. All taxpayers would have to file as single
            2. Only the higher earner would be eligible to claim dependents and other non-dividable tax benefits.

3. Could provide that some or all community property rules ignored for tax purposes

ii. Adopting a flat or flatter tax rate structure to eliminate or reduce distortions in the decision to marry (S.722 (104th Congress), USA Tax Act of 1995, Sens. Nunn and Domenici; Dick Armey testimony before the Senate Appropriations Committee Subcommittee on the District of Columbia (Mar. 8, 2006); Snyder, "Taxation of the New Era 'Family Unit'," Tax Notes 417 (Jan. 21, 2008))

2. Create parity for non-traditional households

a. Repeal DOMA for tax purposes (S.598 (112th Congress), Respect for Marriage Act sponsored by Sens. Feinstein, Bennett, Bingaman, Brown, Cantwell, Cardin, Kerry, Menendez, Schumer, and Wyden)
b. Allow domestic partners to file as married filing jointly and be treated as spouses for purpose of tax expenditures in certain circumstances (S.1171 (112th Congress), Tax Parity for Health Plan Beneficiaries Act of 2011, sponsored by Sens. Schumer, Brown, Cantwell, Cardin, Casey, Collins, Kerry, Menendez, Stabenow, and Wyden)
c. Eliminate a benefit of single filing by domestic partners in community property states by codifying Office of Chief Counsel, IRS Memorandum 200608038

3. Provide targeted marriage penalty relief (S.A.3865 to H.R.4810 (106th Congress), introduced by Sen. Moynihan)

a. Eliminate current EITC marriage penalty relief by making income thresholds identical for married and singles
b. Instead allow lower-earning spouse to claim smaller childless worker EITC

III. EDUCATION

The Internal Revenue Code contains tax benefits for education expenses. The code excludes from income certain education debt forgiveness and provides a deduction for student loan interest. Students are allowed to exclude from income scholarships and fellowships for current expenses. The code also provides several tax credits and a deduction for certain current education expenses. For future expenses, families can save in tax-preferred savings accounts. Definitions and qualifications differ across these tax provisions. For example, most of the tax

provisions contain a phase-out that takes away some or all of the benefit of the provision based on the taxpayer's income. The following table briefly summarizes some of the tax benefits for education.

Current Tax Provisions for Education

Provision	Eligible income	Eligible expenses	Max. benefit in 2013
American Opportunity Tax Credit	Below $90,000 (single filers) and $180,000 (joint filers)	Tuition, fees, and required course materials for first four years of undergraduate education	$2,500 partially refundable credit per year per student
HOPE Credit *(Replaced by AOTC from 2009-17)*	Below $63,000 (single) and $126,000 (joint) in 2008	Tuition and fees for first two years of undergraduate education	$1,800 nonrefundable credit per student (Estimated 2013 levels)
Lifetime Learning Credit	Below $63,000 (single) and $127,000 (joint)	Tuition and fees for higher education and courses to improve job skills	$2,000 nonrefundable credit per year per return
Deduction for Tuition and Fees	Below $80,000 (single) and $160,000 (joint)	Tuition and fees for higher education (Graduate and Undergraduate)	$4,000 above-the-line deduction
Student Loan Interest Deduction	Below $75,000 (single) and $155,000 (joint)	Interest paid on loans taken for higher education tuition, fees, books, supplies and equipment, room and board, and other necessary expenses	$2,500 above-the-line deduction
Personal Exemption for Full Time Students Ages 19-23	Below $372,500 (single) and $422,500 (joint)	N.A.	$3,900 deduction per dependent
Exclusion for Scholarship Income	No income restrictions	Primary, undergraduate, and graduate education tuition, fees, and required course materials	None
Exclusion for discharge of student loans	No income restrictions	Loans taken for higher education tuition, fees, course-related books, supplies, equipment, room and board, and other necessary expenses	None

Qualified Tuition Programs (529s)	No income restrictions	Higher education tuition, fees, books, supplies, equipment, special needs services, and room and board (if at least half-time student)	None
Coverdell Savings Accounts	Below $110,000 (single) and $220,000 (joint)	Higher education and K-12: tuition, fees, books, supplies, special needs equipment, and room and board K-12 only: uniforms, transportation, required items and services, computer	$2,000 contribution per beneficiary
Teacher expense deduction	No income restrictions	Books, supplies, computer equipment and software, and supplementary materials	$250 deduction per teacher

1. **Repeal all education tax expenditures, except the exclusion for scholarships, fellowships, and grants** (Tax Foundation, "Education Tax Subsidies – Justified or Not?," 2008; Scott Hodge testimony before the Finance Committee on July 25, 2012)

2. **Expand tax expenditures for higher education**

   a. Expand tax credit(s) for higher education tuition through some or all of the following reform options: (New America Foundation, "Enhancing Tax Credits to Encourage Saving for Higher Education," 2010; The National Community Tax Coalition, "A Single Higher Education Tax Credit," 2011; Stegmaier, "Tax Incentives for Higher Education in the Internal Revenue Code," 2008; CLASP, "Reforming Student Aid," 2013; S.3267 (112th Congress), The American Opportunity Tax Credit Permanence and Consolidation Act of 2012, sponsored by Sens. Schumer, Kerry, Menendez, and Stabenow)
      i. Make credit fully refundable
      ii. Increase maximum credit amount
      iii. Expand definition of qualified expenses to be similar or identical to Department of Education student grant and loan programs

   b. Expand tax expenditures for education savings account through some or all of the following reforms (Center for Social Development, "College Savings Match Programs: Design and Policy," 2011; Heritage Foundation, "Education Savings Accounts: Giving Families Ownership in Education," 2006; H.R.529 (113th Congress), Savings Enhancement for Education in College Act, sponsored by Rep. Jenkins)

i. Allow taxpayers to claim Saver's Credit for contributions to such accounts
ii. Provide a tax incentive for employers to contribute to employees' accounts

c. Expand income exclusion for Pell Grants to cover all education expenses (The Institute for College Access & Success, "Aligning the Means and the Ends: How to Improve Federal Student Aid and Increase College Access and Success," 2013)
d. All options can be combined with sub-sections (3), (4), and (5) below

3. Consolidate and simplify tax expenditures for education

a. Repeal most or all of the provisions listed in the table above
b. Replace repealed provisions with one of the following:
   i. Single refundable tax credit for tuition for higher education (S.1501 and H.R.2458 (110th Congress), Universal Higher Education and Lifetime Learning Act of 2007, sponsored by Sen. Bayh and Reps. Emanuel and Camp; American Bar Association (ABA), "Tax Simplification Recommendations," 2001; CLASP, "Reforming Student Aid," 2013; PERAB; Dr. Susan Dynarski testimony before the Finance Committee, 2012)
   ii. Refundable tax credit for college tuition, plus tax-preferred education savings accounts (Dr. Waded Cruzado testimony before the Finance Committee, 2012; Finance Committee Chairman's Mark of proposals relating to education incentives, 1999)
   iii. Deduction for higher education tuition and expenses (Heritage Foundation, "Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity," 2011)

4. Conform thresholds and revise definitions

a. If multiple education provisions remain, conform definitions and income thresholds (TPC, "Tax Simplification: Clarifying Work, Child and Education Incentives," 2011; ABA, "Tax Simplification Recommendations," 2001)
b. Provide that only payments to a qualifying educational institution must be reported to the IRS, rather than payments or billed amounts (Government Accountability Office, "Opportunities to Reduce Potential Duplication in

Government Programs, Save Tax Dollars, and Enhance Revenue (GAO-11-318SP)," 2011)

5. **Attempt to increase effect of higher education tax expenditures on college enrollment and completion**

    a. Provide education tax credits at time tuition is due to attempt to heighten effect on educational attainment (CLASP, "Reforming Student Aid," 2013; Dr. Susan Dynarski testimony before the Finance Committee, 2012)
        i. Base credit on prior year's income (with no true-up) so that the credit can be calculated when tuition is due
        ii. Pay credit directly to college or university so that it reduces tuition directly and there is no need to recapture from student if he or she drops out
        iii. Credit could be based on FAFSA and paid by Department of Education (DOE) with Pell grants (Note: Payment by DOE is outside of the Finance Committee's jurisdiction)
    b. Encourage DOE to educate junior high and high school students about college affordability (CLASP, "Reforming Student Aid," 2013)
        i. Permit the IRS to share taxpayer data with DOE so that it can provide each junior high and high school student with an estimate of the cost of attending local colleges, after accounting for tax benefits and direct grants
    c. Better target tax expenditures for education to those least likely to attend college
        i. Disallow further contributions to education savings accounts once combined balance exceeds a certain threshold and enhance information reporting requirements (Dept. of Treasury, "An Analysis of Section 529 College Savings and Prepaid Tuition Plans," 2009)
        ii. Limit qualified distributions from education savings accounts to tuition for post-secondary education (The Institute for College Access & Success, "Aligning the Means and the Ends: How to Improve Federal Student Aid and Increase College Access and Success," 2013)
        iii. Limit tax benefits or apply an excise tax to colleges that engage in legacy admissions (Kahlenberg, "The Legacy Racket," The Century Foundation, 2010)

6. **Provide tax credit to help pay for some private school and post-secondary school costs** (General Explanations of the Bush Administration's Fiscal Year 2003 Revenue Proposals; S.550 (97th Congress), Tuition Tax Relief Act of 1981, sponsored by Sens. Packwood and Moynihan)

    a. Provide a tax credit to parents who send their children to private school
        i. Credit could be limited to cases where taxpayer's child attended a public school that had failed to make "adequate yearly progress" for at least two consecutive years
        ii. Credit could be, for example, 50% of eligible costs incurred up to $5,000
        iii. Eligible costs could include tuition and transportation; could also apply to costs of vocational education
        iv. Credit could be refundable or non-refundable

7. **Expand educational access through tax credit for certain K-12 teachers** (S.378 (112th Congress), Incentives to Educate America's Children, sponsored by Sen. Rockefeller)

    a. Provide a credit to teachers in Title I schools and special education teachers
    b. Potentially limit credit to first three years of teaching in rural schools and second three years of teaching in urban schools to address different needs (recruitment versus retention)
    c. Potentially provide a larger credit for teachers in science, technology, engineering, and math (STEM)

INFRASTRUCTURE, ENERGY, AND NATURAL RESOURCES

Senate Finance Committee Staff Tax Reform Options for Discussion

April 25, 2013

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I. INFRASTRUCTURE

A. CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The federal government collects certain taxes and fees to fund federal and state infrastructure projects. Under current law, there are several trust funds used to fund infrastructure. The most prominent is the Highway Trust Fund. Other trust funds include the Airport and Airway Trust Fund, Harbor Maintenance Trust Fund, and Inland Waterways Trust Fund. The taxes associated with these funds are based on a user-fee model whereby users of the infrastructure system are charged a tax that is related to their use.

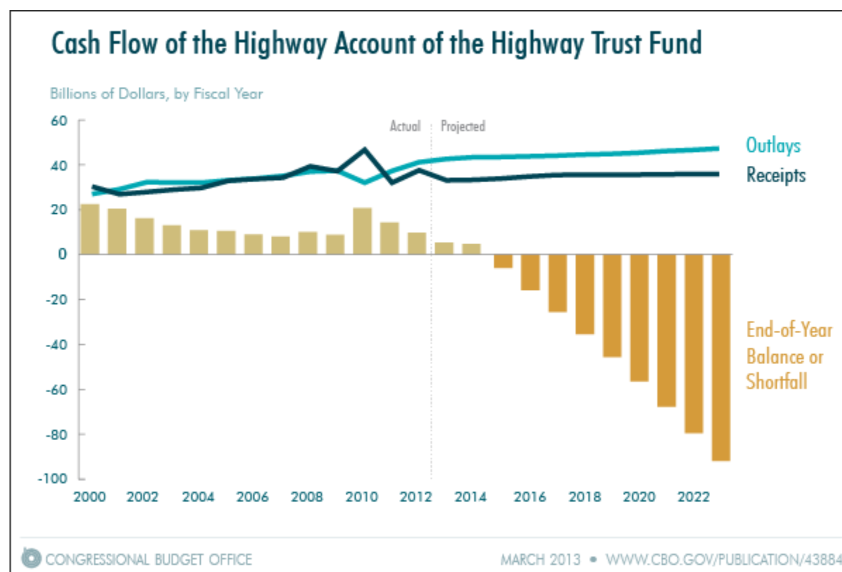
The transportation trust funds are in varying states of solvency relative to authorizations, though technically no trust fund may run a deficit. For example, total revenues (including interest) to the Highway Trust Fund will be approximately $38 billion in FY 2013, while outlays from the Highway Trust Fund, as authorized by the last highway bill, will be approximately $51 billion. In the past, the Finance Committee has at times addressed such shortfalls with additional revenues. Tax reform, in conjunction with sensible spending policy, is an opportunity to ensure the fiscal solvency of federal transportation funds.

Following are some potential broad principles for reform in this area:

- Generate sufficient resources to support federal transportation policy on a sustainable basis
- Ensure that users and direct beneficiaries of infrastructure systems bear the cost of their use
- Promote economic efficiency by maximizing benefits relative to costs for any projects with federal involvement

Some specific concerns about infrastructure funding include the following:

- **Mismatch between amounts authorized and trust fund revenues:** Federal funds dedicated to infrastructure, especially in the Highway Trust Fund, have not always been sufficient to cover spending. As a result, there has been a need for general fund transfers. As illustrated below, the Congressional Budget Office (CBO) projects that in FY 2015, the highway account of the Highway Trust Fund will have insufficient revenues to meet its obligations, resulting in steadily accumulating shortfalls, assuming an extension of baseline spending.



- **Deterioration of the user-fee model:** The federal trust funds for infrastructure were originally designed under the premise that the user-fee model is the most efficient way to fund public goods like infrastructure. However, in recent years, an increasing share of the funding for federal trust funds for infrastructure has come from general revenues. Between 2007 and 2010, about 70% of revenues for highway funding were attributed to motor fuel and vehicle taxes, while 30% came from general sources. Since 2008, shortfalls in the Highway Trust Fund have been replenished by transfers from the general fund totaling $53 billion.

- **Declining revenue from existing sources:** CBO projects that revenues for federal trust funds for infrastructure will fail to keep pace with current spending levels. For example, CBO estimates that the corporate average fuel economy standards (CAFE) will erode fuel tax revenues by 21% by 2040. The federal gas tax is not indexed for inflation and has not been increased since 1993. The barge fuel tax, which funds the Inland Waterways Trust Fund, is also not indexed for inflation.

- **Inadequate funding to meet additional needs:** Some suggest that additional revenue is needed to fund new infrastructure investment on top of maintenance of existing infrastructure. The World Economic Forum's Global Competitiveness Report for 2012-2013 ranks the quality of roads in the United States as 20th in the world. According to the National Surface Transportation Infrastructure Financing Commission, just maintaining the existing conditions and performance of U.S. roads and transit infrastructure would require a 50% increase in current funding levels. The Commission found that over half of the miles that Americans travel on the federal highway system are on roads that are in less than good condition, more than one-quarter of the nation's bridges are structurally deficient or functionally obsolete, and roughly one-quarter of the nation's bus and rail assets are in marginal or poor condition. The backlog of investments in these areas will increase over time. Others believe that existing dollars could be spent more effectively and that reforms should focus on encouraging private investment. They also argue that the state of the nation's infrastructure has been improving in some areas. According to the Cato Institute, the share of bridges in the National Highway System considered structurally deficient or functionally obsolete steadily declined from 1992 to 2011.

- **Uncertainty created by temporary extensions:** In 2005, Congress passed a five-year highway reauthorization bill (SAFETEA-LU). Thereafter, Congress passed 10 short-term extensions before enactment of another highway reauthorization bill in 2012. Since the FAA reauthorization bill in 2005, Congress passed 23 short-term extensions before enacting another reauthorization bill in 2012. According to the Government Accountability Office (GAO), these temporary extensions of transportation trust funds may impede long-term planning and the implementation of projects to improve the nation's infrastructure.

B. REFORM OPTIONS

There are four major federal trust funds for infrastructure. The Highway Trust Fund was established in 1956. It is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs. The Highway Trust Fund is funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles.

The Airport and Airway Trust Fund was created in 1970 to provide funding for national aviation programs. Excise taxes are imposed on amounts paid for commercial air passenger and freight transportation and on fuels used in commercial and general aviation.

The Harbor Maintenance Trust Fund was created in 1986 to fund the operations and maintenance costs for federally-authorized public harbors and channels incurred by the U.S. Army Corps of Engineers. The costs mostly arise from dredging harbor channels to their authorized depths and widths. A tax is imposed on the value of commercial cargo loaded or unloaded by importers or domestic shippers at coastal or Great Lakes ports.

The Inland Waterways Trust Fund (IWTF) was created in 1978 and revised in 1986 for the construction and major rehabilitation of inland waterways. The fund is supported by a per gallon tax on barge fuel. Projects are cost-shared on a 50/50 basis between the IWTF and the general fund. The federal government provides 100% of the operations and maintenance costs for inland waterways.

1. **Limit infrastructure spending to trust fund revenues**

   a. Limit spending from a trust fund in a fiscal year to amounts deposited in the trust fund during that fiscal year (S.A.621 to H.R.2887 (112th Congress), sponsored by Sen. Paul)
   b. Ensure that spending from trust funds is based on an estimate of collections so that trust funds will remain solvent (S.340 (112th Congress), Airport and Airway Trust Fund Reauthorization Act of 2011, sponsored by Sen. Baucus)
   c. Prohibit borrowing from the general fund

2. **Devolve federal revenues to states**

   a. For example, remit revenues from existing federal taxes and fees that are deposited in the federal Highway Trust Fund to the states according to their share of revenue collected, with no restrictions on how states use the funds and no change to current tax and fee mechanisms (S.1446 (112th Congress), State Transportation Flexibility Act, sponsored by Sen. Coburn)
   b. Reform federal requirements and mandates applicable to states, for example, by reforming or repealing Davis-Bacon requirements (Recommendation in a letter from seven Finance Committee Republicans, dated December 2, 2011) (Note: This proposal would not be in Finance Committee jurisdiction)

3. **Maintain the user fee model but increase existing taxes and fees**

   a. Increase or index fuel taxes (National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009; Committee Amendment 38 (112th Congress), to the Highway Investment, Job Creation, and Economic Growth Act of 2012, proposed by Sen. Enzi)

      For example:

      i. Increase Highway Trust Fund tax rates by 10-15¢/gallon to meet current spending levels plus inflation; current tax rates are 18.3¢/gallon on gas and 24.3¢/gallon on diesel
      ii. Increase the Inland Waterways Trust Fund tax rate on barge fuels from the current tax rate of 20¢/gallon to, for example, 29¢/gallon (Inland Waterways User Board, "24th Annual Report," 2010; S.407 (113th Congress), Reinvesting In Vital Economic Rivers and Waterways Act of 2013, sponsored by Sen. Casey)

b. Increase other dedicated taxes and fees that fund the Highway Trust Fund
    i. For example:
        1. Increase the truck and trailer sales tax by 1%
        2. Increase the truck tire tax by 1¢ for every 10 pounds of maximum capacity
        3. Increase the heavy vehicle use tax by 10%
    ii. Collectively, the truck and trailer, truck ownership and tire excise taxes raise less than 10% of total Highway Trust Fund revenue (National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009)

c. Convert the fuel excise tax to a sales tax that is a percentage of the cost of the fuel rather than a fixed amount (H.B.2313, Revenues and Appropriations of State, sponsored by Virginia State Rep. Howell; The American Association of State Highway and Transportation Officials, "Possible Option of How to Sustain Baseline Funding for Highways and Transit through FY2015," 2010)

4. Establish new user fees and taxes to replace or supplement current user fee system

a. Replace the current gas tax with a hybrid tax structure designed to provide relief when gas prices increase by lowering taxes, and then to increase taxes when gas prices fall (Carnegie Endowment, "Road to Recovery: Transforming America's Transportation," 2011)
    i. Hybrid structure would combine a variable fuel tax with a per barrel fee on domestic and imported oil
        1. Gasoline and diesel taxes would increase when oil prices were low and decrease when oil prices increased
        2. Per barrel fee on oil (at production or importation) would vary inversely

b. Institute a vehicle-miles-traveled tax
    i. Tax would be a certain amount per mile travelled and could be adjusted based on the type of vehicle and the time and place of travel
    ii. Could be used to replace the existing system or could be adopted in certain parts of the country (potentially as pilots) to supplement existing fees and taxes; Oregon state has been conducting a pilot program since 2006 (National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009)

c. Establish surcharges on drivers' licenses and vehicle registration (National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009)
d. Set new fees for hybrid and other efficient vehicles (E.H.B.2660, Addressing Transportation Revenue, sponsored by Washington State Rep. Clibborn; H.B.2313, Revenues and Appropriations of State, sponsored by Virginia State Rep. Howell)
e. Establish an annual user fee for commercial shippers utilizing inland waterways
    i. For example, establish a lock usage fee to replace the current barge fuel tax (FY14 Administration Budget Proposals, estimated in 2012 to raise $1 billion over 10 years)
    ii. Commercial vessels using only inland waterways could pay one rate while commercial shippers using inland waterways and locks would pay a higher fee (The President's Plan for Economic Growth and Deficit Reduction, September 2011)
f. Expand use taxes to bicyclists, for example, through an excise tax on bicycles (H.B.1954, Addressing Transportation Revenue, sponsored by Washington State Rep. Clibborn)
g. Repeal existing taxes and fees that support one or more infrastructure trust funds, and replace with revenue from a carbon tax on transportation fuels (discussed on p. 15 below) (National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009)

5. Designate other sources of revenue for Highway Trust Fund

a. Increase leases for oil and gas production and dedicate revenue to the Highway Trust Fund (S.17 (113th Congress), Energy Production and Project Delivery Act of 2013, sponsored by Sen. Vitter) (Note: This proposal would not be in Finance Committee jurisdiction)

6. Provide additional financing options for states

a. Authorize additional private activity bonds for infrastructure projects
    i. For example, eliminate the state volume cap on private activity bonds for water projects (S.939 (112th Congress), Sustainable Water Infrastructure Act, sponsored by Sen. Menendez) or increase the current $15 billion limitation on transportation projects to $19 billion (FY14 Administration Budget Proposal)
b. Provide direct subsidy bonds
    i. Create a new, direct subsidy bond that provides, for example, a 28% subsidy on the interest rate to the issuer of bonds to fund infrastructure projects (FY14 Administration Budget Proposal, estimated in 2012 to cost $7 billion over 10 years)
        1. Could limit to bonds issued by state and local governments, or could also permit bonds issued by public-private partnerships
c. Provide tax credit bonds
    i. Create new tax credit bonds for infrastructure projects that provide the bondholder with a tax credit equal to, for example, 28% of the interest on the bond instead of exempting the interest from tax
        1. Tax credit bonds exist for alternative energy projects, school rehabilitation, and other purposes
        2. Could limit new bonds to those issued by State infrastructure banks for transportation projects (S.1436 and H.R.3736 (112th Congress), Transportation Regional Infrastructure Project Bonds Act, sponsored by Sen. Wyden, Rep. Whitfield)
d. Establish a National Infrastructure Bank to provide loans for transportation infrastructure projects
    i. Appropriate, for example, $10 billion to capitalize a bank independent of any federal agency that would provide loans and loan guarantees (S.652 (112th Congress), Building and Upgrading Infrastructure for Long-Term Development Act, sponsored by Sen. Kerry; FY14 Administration Budget Proposal) (Note: This bill was referred to the Finance Committee)
    ii. Appropriate, for example, $10 billion to establish a lending authority within the Department of Transportation to provide loans, loan guarantees, and grants (S.387 (113th Congress), American Infrastructure Investment Fund Act, sponsored by Sen. Rockefeller) (Note: This proposal would not be in Finance Committee jurisdiction)

1. Under current law, 23 states have infrastructure banks. There is no national infrastructure bank but programs such as the Transportation Infrastructure Finance Innovation Act (TIFIA) provide credit support, loans and loan guarantees for surface transportation programs administered by the Department of Transportation.

e. Reduce taxes on foreign investment in U.S. infrastructure
   i. Relax the Foreign Investment in Real Property Tax Act's (FIRPTA) requirement that certain real estate investment trusts with foreign investors pay tax on gains on the sale of U.S. real estate (S.1616 (112th Congress), Real Estate Investment and Jobs Act of 2011, sponsored by Sens. Menendez and Enzi)
   ii. Exempt foreign pension funds from the FIRPTA tax on gains on the sale of U.S. real estate and infrastructure (FY14 Administration Budget Proposal)

I. ENERGY AND NATURAL RESOURCES

A. CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The tax code currently contains provisions that play a significant role in the domestic energy market. Certain tax expenditures promote domestic energy production, while others incentivize energy conservation and energy efficiency. There are a variety of energy-related tax expenditures in the form of refundable credits, nonrefundable credits, deductions, and accelerated depreciation schedules. CBO estimates that, in FY2013, energy-related tax expenditures will cost $16 billion in foregone revenue, while federal spending on energy will be $3 billion. Among energy-related tax expenditures, 45% will go to renewable energy, 29% to energy efficiency, 20% to fossil fuels, and 7% to nuclear energy. To the extent that a reformed tax system includes energy tax expenditures, they should be structured to be efficient and effective. Following are some potential broad principles for reform in this area:

- To the extent the tax code includes tax expenditures for energy and conservation, the tax code should:
  - Provide businesses with greater certainty
  - Consolidate and simplify such tax expenditures
  - Make such tax expenditures fairer and more efficient
  - Encourage energy independence through a comprehensive approach
  - Carefully consider whether and how to address any positive or negative externalities

Some specific concerns about tax expenditures related to energy and the environment include the following:

- **Distortion of investment decisions:** Some are concerned that energy tax subsidies distort investment choices, which may hamper economic growth, and believe that the tax code should instead focus on equitably and efficiently collecting revenues.

- **Accounting for externalities:** Measuring externalities is difficult and imprecise. Especially in the area of carbon, estimates of externalities are wide-ranging. Some economists believe that energy tax expenditures enhance economic efficiency to the extent that they address externalities associated with pollution. Specifically, they believe that the lack of a price on pollution, such as emissions of CO_2 and other harmful greenhouse gases, is a market failure because pollution produces costs that are not borne by the polluter (e.g., detrimental effects on human health, agricultural productivity, and coastal infrastructure). Further, some economists find that market-based measures, such as taxes, are a more efficient way to correct for this market failure than regulation. Others are concerned that taxing pollution or carbon could adversely affect U.S. competiveness if other countries are not taking similar measures. They are also concerned about the potential impact of such taxes on economic growth and jobs. However, the revenue raised by such a tax could be used to reduce other taxes or to make public investments.

- **Duplication with spending programs:** Some believe that tax benefits and direct spending programs should be more coordinated. According to GAO, 23 agencies, including 130 sub-agencies, implemented 679 renewable energy initiatives in fiscal year 2010. In some cases, these initiatives involved multiple programs or tax expenditures serving a similar purpose. For example, GAO identified 82 wind-related initiatives of which 83% overlapped to some degree with another initiative. However, GAO also noted such overlapping initiatives did not necessarily result in a duplication of efforts because they sometimes differed in meaningful ways. In addition, under current law, there are limits on the extent to which individual projects can receive support from multiple initiatives. For example, taxpayers must reduce the value of some federal tax credits for energy by amounts they have received in grants, tax-exempt bonds, subsidized energy financing, and other tax expenditures.

- **Neutrality across different technologies:** Current law provides a variety of incentives for specific energy technologies. Some believe that it would be more efficient to structure these incentives, to the extent they are retained, on a technology-neutral basis. They argue that such an approach would be more effective at accommodating and encouraging technological advances and would avoid picking winners and losers among competing technologies. Others believe that the choice of any "technology-neutral" standard itself is subjective. Some are also concerned that a technology-neutral approach could have unintended consequences. For example, when Congress established a tax credit for producing biofuels from alternative fuel technology, the pulp and paper industry was able to claim credits worth billions of dollars for a byproduct of their manufacturing process called "black liquor."

- **Overall complexity:** Multiple provisions for the same purpose create complexity and some would argue diminish their effectiveness. The tax code currently includes about 40 energy-related provisions, including provisions for fossil fuel, alternative electricity generation, alternative fuels and alternative fuel vehicles, and energy efficiency, as well as provisions for nuclear, CO_2 abatement, and other purposes.

- **Temporary nature of certain tax expenditures:** Some are concerned that the temporary nature of expiring tax expenditures creates uncertainty for taxpayers, makes it difficult for businesses to plan and may diminish their effectiveness. On the other hand, some argue that allowing energy tax expenditures to expire ensures that the tax code is not subsidizing industries and technologies once they have become competitive, resulting in a higher bang for the buck, and preventing favored industries from receiving permanent tax expenditures. By CBO's last count, there were 27 energy tax expenditures set to expire between 2011 and 2022. Permanently extending these provisions would cost about $120 billion.

- **Low bang-for-the-buck for tax incentives:** Some argue that energy-related tax incentives could achieve more at a lower cost. For example, some research suggests when consumers are purchasing a car, they are "myopic" in the sense that they focus on sticker prices and do not fully account for the fuel savings over time. This implies that tax expenditures that are delivered earlier in time may be more effective. However, others believe consumers act rationally when making consumption decisions.

- **Limited business effect of tax incentives that defer tax liability:** Some energy tax expenditures allow businesses to pay tax later than it would otherwise be due. Such timing changes do not affect the nominal amount of taxes due, although they can be very valuable due to the time value of money. For example, accelerated depreciation for energy-related investments means that a business pays less tax in the years immediately following the purchase of the asset, but pays correspondingly more tax later in the useful life of the asset. Many, but not all, publicly-traded corporations and certain private businesses plan with a focus on financial statement income. Others rely more on cash flow, which helps finance operations when other financial sources are unavailable. In general, tax deferrals do not impact financial statement income and, as a result, may not affect business behavior in some cases. Therefore, to incentivize business behavior, it may be more effective to replace energy tax incentives that defer tax liability with other types of tax incentives, such as rate reductions or credits.

B. REFORM OPTIONS

1. Eliminate all existing tax expenditures for the energy sector

a. Eliminate some or all existing tax expenditures, including the following (H.R.259, (113th Congress), S.2064 (112th Congress), The Energy Freedom & Economic Prosperity Act, sponsored by Rep. Mike Pompeo and Sens. DeMint and Lee; S.329 (113th Congress), the Sustainable Energy Act, sponsored by Sens. Sanders and Boxer; proposal by Rep. Fred Upton in October 2012)
   i. Permanent tax expenditures
      1. Oil- and gas-specific tax expenditures, such as expensing of intangible drilling costs
      2. Accelerated depreciation for alternative energy assets
      3. Investment tax credit for solar and geothermal electricity
   ii. Temporary tax expenditures
      1. Electricity: Investment tax credit for solar and other resources (expire at the end of 2016) and production and investment tax credits for wind and other resources (expire at the end of 2013)
      2. Biofuels: Tax credits for biodiesel and advanced ethanol (expire at the end of 2013) and for liquefied hydrogen and hydrogen refueling property (expire at the end of 2014)
      3. Vehicles: Tax credits for vehicles utilizing fuel cell technology (expire at the end of 2014) and plug-in electric drive motor vehicles (phase-out after a manufacturer sells 200,000 vehicles)

2. **Replace existing energy tax expenditures with technology-neutral tax expenditures**

   a. Repeal existing energy tax expenditures for targeted industries or technologies and replace them with one or more technology-neutral tax incentives such as the following (Testimonies of Dr. Gilbert Metcalf and Dr. David Greene before the Committee on Finance, April 23, 2009):

      i. Establish a new, performance-based tax credit for residential energy efficient retrofits of, for example, $2,000 if the retrofit makes the home 20% more efficient, regardless of what technology is used (S.1914 (112th Congress), Cut Energy Bills at Home Act, sponsored by Sens. Bingaman, Snowe, and Feinstein)

      ii. Create a new tax credit for transportation-quality biofuel based on the total carbon reduction of the fuel compared to gasoline or diesel fuel (S.3338 (111th Congress), Advanced Biofuel Investment Act of 2010, sponsored by Sen. Nelson; Union of Concerned Scientists, "The Billion Gallon Challenge," 2010)

      iii. Establish a new tax credit for the purchase of energy efficient vehicles based on fuel efficiency alone compared to the corporate average fuel economy (CAFE) for the vehicle's class instead of the existing credits for specific types of fuel efficient technology, such as plug-in hybrid cars or fuel cell vehicles (S.1620 (111th Congress), Efficient Vehicle Leadership Act of 2009, sponsored by Sens. Bingaman, Kerry, Snowe, and Lugar)

      iv. Create a new production tax credit for electricity based on the energy content (in British thermal units or BTUs) of the energy source; could be based on the pollution or carbon content instead of BTUs (S.306 (111th Congress), Biogas Production Incentive Act of 2009, sponsored by Sens. Nelson, Brown, Crapo, Hatch, Isakson, Stabenow, Thune, Wyden, and others)

      v. Create a program that allocates tax credits on a technology-neutral basis, such as the Section 48C program which provided a 30% investment tax credit for advanced manufacturing facilities (S.1764 (112th Congress), Make it in America Tax Credit Act, proposed by Sen. Stabenow)

3. **Modify and consolidate some incentives while eliminating others**

    a. Modify existing energy tax expenditures to reduce the total number and cost of tax expenditures while making them permanent

        i. Make refundable and permanently extend the alternative electricity production tax credit (section 45) and the deduction for energy efficient commercial buildings (section 179D) (FY14 Administration Budget Proposal)

        ii. Make permanent the individual tax credit for energy efficient home retrofits (H.R.6398 (112th Congress), Home Energy Savings Act of 2012, sponsored by Reps. Gerlach and Neal)

        iii. Repeal certain tax credits, such as the wind production tax credit or solar investment tax credit, and replace them with expensing or accelerated depreciation (H.R.2652 (110th Congress), Generating Renewable Energy and Encouraging Novel Technologies Act of 2007, sponsored by Rep. English)

    b. Replace all energy tax expenditures that defer tax (through accelerated depreciation or other enhanced deductions) with provisions that provide an immediate tax benefit (through a credit or rate reduction)

        i. For example, replace the section 179D deduction for energy-efficient commercial building property with a tax credit of up to $1.80 per square foot (FY13 Administration Budget Proposal, estimated in 2012 to cost $1 billion over 10 years)

    c. Modify the carbon dioxide sequestration credit allocation rules to provide more certainty for taxpayers (S.3581 (112th Congress), sponsored by Sens. Conrad, Enzi, and Rockefeller)

4. **Equalize tax treatment of master limited partnerships (MLPs) in the energy sector**

    a. Extend the ability of certain MLPs to pay tax on a pass-through basis to MLPs in the renewable energy sector (S.3275 (112th Congress), Master Limited Partnership Parity Act, sponsored by Sen. Coons)

        i. Current law allows certain publicly-traded businesses in the oil, gas, mineral and real estate sectors to pay tax on a pass-through basis; most publicly-traded businesses must pay the corporate income tax

b. Alternatively, deny pass-through tax treatment to all MLPs in the energy sector, thereby treating fossil fuel and renewable energy producers equally in this regard (S.3080 (112th Congress), End Polluter Welfare Act of 2012, sponsored by Sen. Sanders)

5. **Establish a carbon tax or cap and dividend approach while eliminating most or all other existing energy tax expenditures**

    a. Eliminate most or all existing tax expenditures for the energy sector and create a new federal excise tax on the sale or importation of fossil fuels (H.R.3242, (112th Congress), Save Our Climate Act of 2011, sponsored by Rep. Stark; S.332 (113th Congress), Climate Protection Act of 2013, sponsored by Sens. Sanders and Boxer; National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009; Mankiw, "One Answer to Global Warming: A New Tax," 2007; Shultz and Becker, "Why We Support a Revenue-Neutral Carbon Tax," 2013)
        i. Design issues to consider include: Whether to impose the tax upstream or downstream, how to set the price, whether and how to phase-in the tax, how to deal with cross-border issues, and whether to include an adjustment mechanism for taxpayers that invest in CO_2 capture and sequestration or energy efficiency
        ii. If policymakers decide to maintain the current level of progressivity, a challenge with this option would be how to do so
    b. Alternatively, follow a cap and dividend approach (S.2877 (111th Congress), Carbon Limits and Energy for America's Renewal Act, sponsored by Sen. Cantwell)

6. **Modify conservation easements**

    a. Make permanent the expansion of the charitable deduction for contributions of conservation easements (S.526 (113th Congress), The Rural Heritage Conservation Extension Act of 2013, sponsored by Sens. Baucus, Hatch, Collins, Heinrich, Heller, Shaheen, Stabenow, Tester, Udall and Whitehouse)
    b. Increase the limitation on the estate tax exclusion for land subject to a qualified conservation easement (S.1901 (112th Congress), American Family Farm and Ranchland Protection Act of 2011, sponsored by Sens. Udall and Crapo)
    c. Repeal the deduction for contributions of conservation easements and replace with a refundable tax credit capped at a limited dollar amount (Halperin, "A Better Way to Encourage Gifts of Conservation Easements," Tax Notes 307, 2012)

INTERNATIONAL COMPETITIVENESS

Senate Finance Committee Staff Tax Reform Options for Discussion

May 9, 2013

This document is the fifth in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT LAW

The United States income tax rules applying to cross-border income are based on two core concepts: the *residence* of the taxpayer and the *source* of the taxpayer's income. For nearly a century, the U.S. and other countries have tried to ensure that income earned by a resident of one country from a source in another country is not taxed twice. Some countries, including the U.S., have mitigated double taxation by giving a credit to their residents for income taxes paid to the source country. Other countries, like the Netherlands, have mitigated double taxation by exempting their residents from tax on foreign dividends paid from active business income that was taxed in the source country.

Under the U.S. credit-method system, residents generally must pay tax annually on their global income and can claim a credit for foreign income taxes paid (the "foreign tax credit") to prevent double-taxation. The rules are more complicated if the taxpayer is a U.S. multinational earning foreign income through a foreign subsidiary. In this case, the U.S. parent company generally does not owe any U.S. tax on its subsidiary's foreign earnings until the earnings are repatriated, typically by way of a dividend. The ability of a U.S. multinational to delay paying U.S. tax on their foreign subsidiaries' earnings is called "deferral" (a term that is also used in other non-international areas of the tax code). However, under the "subpart F" rules, a U.S. multinational still must pay tax immediately on the foreign earnings of controlled foreign corporations (CFCs) to the extent that the income is passive, mobile, or invested in certain U.S. property.

The impact of the subpart F rules is often reduced through tax planning that utilizes the "check-the-box" rules and the CFC look-through rule. The check-the-box rules, issued by the Treasury Department in 1996, are entity classification rules that provide a streamlined process to designate certain business entities as corporations or alternatively as pass-through or disregarded entities. This streamlined process enables U.S. multinationals to disregard, for U.S. tax purposes, certain controlled business entities and transactions between those entities and other affiliated companies within the corporate group. The CFC look-through rule, enacted in 2006, treats dividends, interest, rents, and royalties received by a CFC from a related CFC as active income not subject to current U.S. tax under subpart F if the payor CFC derives its income from active business activities.

The U.S. tax system also includes special rules for U.S. investors who own stock in a foreign corporation holding mainly investment assets, which is referred to as a "passive foreign investment company" (PFIC). The PFIC rules limit a U.S. person's ability to defer U.S. tax liability on their share of the PFIC's income.

Other developed countries have various anti-abuse rules similar to our subpart F and PFIC rules. These rules are intended to prevent their residents from shifting passive income and other types of mobile income to foreign subsidiaries in order to avoid or defer paying tax in their home country. In addition, most countries have rules to prevent related parties (such as two companies owned by the same parent) from making contracts that shift income to a lower-tax country. These "transfer pricing" rules require related parties transacting with each other to use, for tax purposes, the prices that unrelated parties would use, also known as "arm's length" prices.

Like other countries using the credit-method system, the U.S. limits the amount of foreign tax credits that a taxpayer can claim to the amount of U.S. tax the taxpayer would owe on their net foreign income if it were earned in the U.S. This limit on foreign tax credits is applied separately to two “baskets” of a taxpayer’s foreign income: passive and non-passive income. These baskets mean that a taxpayer cannot use foreign tax credits derived from foreign active income to reduce the U.S. tax they owe on foreign passive income, and vice versa.

Nevertheless, within these two baskets, foreign tax credits derived from items of highly-taxed income can be used to offset U.S. tax on items of lower-taxed income. This ability to reduce the U.S. tax due on foreign income earned in a low-tax country through foreign tax credits received on foreign income earned in a high-tax country is known as “cross-crediting.”

Under current law, there are also limits on the extent to which “dual capacity” taxpayers can claim foreign tax credits. A dual capacity taxpayer is one that receives a specific economic benefit from another country, such as the right to extract natural resources or operate a casino. When a dual capacity taxpayer is subject to a higher tax rate than other taxpayers that are not receiving a specific economic benefit, the taxpayer may not be able to claim a foreign tax credit for this extra tax if it represents a fee or royalty.

All of the rules described above require U.S. taxpayers to determine what portion of the income they earn is U.S. versus foreign income. A complicated set of rules determine the source of different items of income. For example, income from services is “sourced” to the U.S. if the service is performed in the U.S. and “sourced” to a foreign country if the service is performed abroad. Another complicated set of rules determine how expenses, such as interest payments, are allocated to U.S. versus foreign income.

The rules described above also assume that the taxpayer is subject to U.S. tax. All U.S. persons, whether an individual or corporation, are subject to U.S. tax. However, foreign individuals and foreign corporations are generally only subject to U.S. tax if they earn U.S. source income. The rates they pay depend on whether their U.S. source income is effectively connected to a U.S. trade or business in which they are engaged. If it is, they pay tax on their net income at our graduated income tax rates. If it is not, they must pay a 30% flat tax on their gross income, which is withheld by the payor.

The U.S. has 67 bilateral income tax treaties, which often substantially change the U.S. tax treatment of non-resident foreign individuals and foreign corporations. In general, our income tax treaties lower the 30% withholding tax on U.S. source dividends, interest, and royalties paid to a treaty-country resident, sometimes to zero. Our income tax treaties also typically bar the U.S. from taxing the business profits of a non-resident foreign individual or foreign corporation unless they have a permanent establishment in the U.S.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

In an increasingly global economy, our international tax rules have become more important for the competitive position of the U.S. economy and U.S. businesses. We are competing with other nations for investment, both from U.S. businesses and foreign businesses. At the same time, U.S. companies are competing with foreign companies for business in foreign markets. Yet our international tax rules have not been substantially reformed since 1962, when exports as a share of GDP were 5%. Today, exports are 14% of GDP.

Tax reform is an opportunity to strengthen the competitiveness of the U.S. in the global economy. It is also an opportunity to improve the tax system by making it more fair, efficient, clear, and simple. Following are some potential broad principles for reform in this area:

- Increase U.S. competitiveness and job creation by reducing tax barriers to U.S. and foreign multinationals investing in the U.S.
  - Reduce tax incentives for multinationals to be foreign-based (either by incorporating abroad or being acquired by foreign multinationals)
  - Reduce tax incentives for U.S. multinationals to keep foreign earnings abroad rather than bringing them back for U.S. investment
- Prevent base erosion and profit shifting to low-taxed foreign entities lacking relevant business substance
- Reduce complexity, uncertainty, and compliance burdens

Specific concerns about our international tax system today include the following:

- **Competitiveness:** U.S. corporations generally pay tax at a federal statutory rate of 35% on their foreign earnings (reduced by foreign tax credits), either immediately or when such earnings are repatriated. Their competitors in foreign countries typically pay tax on their foreign earnings at a lower statutory rate (and, some believe, a lower effective rate). Their competitors also are not taxed significantly, if at all, on repatriated foreign earnings. Some are concerned that these features of our tax system put U.S. multinationals at a competitive disadvantage by reducing the after-tax return they can offer investors, which in turn increases their cost of capital compared to a typical foreign competitor. Others believe that our tax system does not put U.S. multinationals at a competitive disadvantage because U.S. multinationals' average effective tax rates are in line with those of our competitors and the U.S. offers other competitive advantages, such as strong intellectual property protections.

  If U.S. multinationals do face a higher cost of capital (whether actual or perceived) because of our tax system, this may result in foreign companies being able to outbid U.S. companies for profitable business opportunities. It may also result in a decline in U.S.-resident multinationals as new businesses incorporate abroad and existing U.S. businesses are acquired by foreign companies.

  Some believe that a decline in the share of global income earned by U.S. multinationals, as opposed to foreign multinationals, would adversely affect U.S. growth and jobs. While the evidence is mixed, some research suggests that U.S. multinationals have a "home country bias," meaning that they are more likely to hire U.S. workers and purchase inputs from U.S. companies than their foreign competitors.

- **Base erosion and profit shifting:** Some multinationals minimize their tax burden by using planning strategies that shift income from a high-taxed affiliate to a low-taxed affiliate. They do so for income derived from both U.S. and foreign customers. This tax planning is possible through a combination of factors, including tax treaties, the ability to treat different subsidiaries as separate entities, and the ways in which multinationals set prices for transactions between their subsidiaries. Typically, multinationals seek to reduce their tax burden by arranging their affairs so that subsidiaries resident in low-tax countries receive as much income as possible through ownership of valuable intangibles, the provision of financing, and the assumption of business risks. They also seek to allocate payments of deductible interest and royalties to affiliates in higher-tax countries, which reduces their tax base in those countries.

Estimates of the amount of taxable income shifted by U.S. multinationals to low-tax countries from other countries (not necessarily only the U.S.) through base erosion and profit shifting range from $58 billion to $111 billion per year. Base erosion and profit shifting by global corporate groups has become a political issue in a number of countries including the UK, France, and Germany. The G-20 countries, which include the U.S., are discussing a range of alternatives to address profit shifting to tax haven entities that lack business substance.

- **Lockout effect:** The ability of U.S. multinationals to defer paying U.S. tax on some foreign earnings until they are repatriated creates a disincentive for U.S. multinationals to repatriate such earnings and invest them in the U.S. This is known as the "lockout effect." This disincentive does not exist if the foreign earnings are taxed abroad at a higher rate than the U.S. rate. But the U.S. has one of the highest statutory corporate tax rates compared to other countries. In addition, through tax planning, some U.S. multinationals shift income from high-tax foreign subsidiaries to low-tax foreign subsidiaries. This further reduces the foreign tax rate on their foreign income, exacerbating the lockout effect.

  The lockout effect may be heightened for U.S. multinationals that make business decisions with an eye towards the impact on their "book" income. Most U.S. multinationals that are publicly-traded focus primarily on book income meaning that avoiding financial accounting income tax expense is at least as important to them as avoiding cash taxes (if not more important). Under U.S. financial accounting rules, if a U.S. multinational has a foreign subsidiary that does not intend to pay dividends to the U.S. parent, the subsidiary's earnings are considered to be "permanently reinvested" abroad. This means that the U.S. parent does not have to account in its financial statements for the ultimate U.S. tax that will be due when the subsidiary's foreign earnings are repatriated. Therefore, keeping foreign earnings offshore can enhance a U.S. multinational's earnings for financial accounting purposes by reducing the company's overall effective tax rate.

  Many U.S. multinationals have accumulated large amounts of permanently reinvested earnings in foreign subsidiaries, including tax haven entities. According to research published by JP Morgan, the total amount is around $1.8 trillion.

- **Nonresident citizens:** U.S. citizens living abroad are generally taxable as residents of the foreign country where they live. They are also required to file U.S. federal income tax returns annually and pay tax to the U.S. on their worldwide income, subject to the foreign tax credit and an exclusion for a limited amount of foreign-earned income. Other countries generally tax their nonresident citizens only on income their citizens earn in their country of citizenship. Some believe certain employers overseas are reluctant to hire U.S. citizens because of the associated tax burden and compliance costs.

REFORM OPTIONS

I. BASE EROSION AND DEFERRAL

1. Tighten anti-base-erosion rules and reform the treatment of non-subpart F earnings

a. Redefine the earnings subject to immediate taxation under subpart F through one of the following:
   i. Immediately tax all income of relatively low-taxed CFCs, except income from substantial activities in foreign markets (S.2091 (112th Congress), United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi; Ways and Means Committee Discussion Draft on International Tax Reform: Option B, 2011; this is also the law in certain other countries, including Germany and Japan)
   ii. Immediately tax income of a relatively low-taxed CFC that exceeds the income proportionate to the CFC's share of the multinational group's business operations, based on factors such as the CFC's tangible assets and payroll (Avi-Yonah, Clausing, and Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," Florida Tax Review, 2009)

b. "Minimum Tax" on CFC earnings:
   i. For income taxed below a minimum foreign effective tax rate, immediately apply U.S. tax at a designated minimum tax rate or full U.S. rates (subject to foreign tax credits in both cases) (President's Framework for Business Tax Reform, 2012; Ways and Means Committee Discussion Draft on International Tax Reform: Option B, 2011)

            1. Provide an exception for income from sales or services in the CFC's country of incorporation. (Ways and Means Committee Discussion Draft on International Tax Reform: Option B, 2011)
    ii. Immediately tax at, for example, a 15% rate (subject to foreign tax credits) all intangibles-related income of CFCs and of the U.S. parent from sales in foreign markets, with no further U.S. tax upon repatriation (Ways and Means Committee Discussion Draft on International Tax Reform: Option C, 2011)
    iii. Immediately tax all income of CFCs, at, for example, a 15% rate (subject to foreign tax credits) except for the amount spent on tangible capital assets in the CFC's home country (Grubert and Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," 2013)

c. In addition to (a) or (b), move to an exemption system through one of the following:
    i. Exempt, for example, 95% of dividends received by a U.S. corporation from a CFC, and 95% of gains on the sale of CFC stock, while allowing deductions for expenses related to exempt dividends and gains (S.2091 (112th Congress), United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi; Ways and Means Committee Discussion Draft on International Tax Reform, 2011)
        1. Could immediately tax remaining 5% of CFCs' earnings each year, reduced by any tax under (a) or (b) (Sullivan, "Designing Anti-Base Erosion Rules," Tax Notes, 2013)
    ii. Exempt, for example, 100% of dividends received by a U.S. corporation from a CFC, and 100% of gains on the sale of CFC stock, but disallow deductions for expenses related to exempt dividends (Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," 2005; President's Advisory Panel on Federal Tax Reform, 2005)
    iii. Together with (i) or (ii) above, apply one of the following to foreign branch operations:
        1. 95% or 100% exemption could cover foreign branch profits (The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth", 2010; similar to the law in Hong Kong)

2. Could deem foreign branches to be CFCs and therefore qualify for the exemption (Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," 2005; Ways and Means Committee Discussion Draft on International Tax Reform, October 2011)

iv. Together with (i) or (ii) above, impose a transitional "toll charge" on accumulated, untaxed, pre-enactment earnings of CFCs (S.2091 (112th Congress), United States Job Creation and International Tax Reform Act of 2012, sponsored by Sen. Enzi; Ways and Means Committee Discussion Draft on International Tax Reform, 2011)

1. Could be mandatory and payable over a period of years
2. Could be elective

2. Strengthen the subpart F rules through one or more of the following

a. Immediately tax all income of relatively low-taxed CFCs from sales of property or services used or consumed in the U.S. (S.260 (111th Congress), A bill to… provide for the taxation of income of controlled foreign corporations attributable to imported property, sponsored by Sen. Dorgan)
b. Immediately tax all income of relatively low-taxed CFCs on intangible property transferred from a related U.S. party to the extent that it is deemed to exceed a reasonable return (FY2014 Administration Budget Proposals; estimated in 2012 to raise $19 billion over 10 years; Ways and Means Committee Discussion Draft on International Tax Reform: Option A, October 2011)
c. Apply the subpart F rules separately to each foreign business unit within, or controlled by, a CFC (FY2010 Administration Budget Proposals; estimated in 2010 to raise $31 billion over 10 years; S.268 (113th Congress), CUT Loopholes Act of 2013, sponsored by Sen. Levin)
d. Treat interest and royalties received from a related CFC as subpart F income regardless of whether the payor derives its income from active business activities (S.268 (113th Congress), CUT Loopholes Act of 2013, sponsored by Sen. Levin)
e. Repeal rule treating CFCs' investments in U.S. property as taxable income of the controlling U.S. shareholder(s) (Dilworth, "U.S. Federal Income Tax Reform: International Recommendations," Tax Notes, November 8, 2010)

3. Repeal deferral for CFCs (S.727 (112th Congress), Bipartisan Fairness and Tax Simplification Act of 2011, sponsored by Sens. Wyden and Coats)

a. Include all earnings of CFCs in the U.S. parent company's income each year, with foreign tax credits

4. **Strengthen thin-capitalization rules to limit base erosion through excessive debt financing** (Ways and Means Committee Discussion Draft on International Tax Reform, October 2011; similar to the law in Germany and Italy)

   a. Disallow interest expense deductions by a U.S. corporation to the extent that net interest expense exceeds, for example, 25% of adjusted taxable income
   b. Create an exception for any U.S. taxpayer that is not more highly leveraged than the worldwide group of which it is a part
   c. Allow nondeductible interest to be carried forward and deducted in future years

5. **Strengthen rules against U.S. base erosion by foreign companies**

   a. Restrict deductions for reinsurance premiums paid to untaxed offshore affiliates (FY2014 Administration Budget Proposals; estimated in 2012 to raise $13 billion over 10 years; S.1693 (112th Congress), A bill to… prevent the avoidance of tax by insurance companies through reinsurance with non-taxed affiliates, sponsored by Sen. Menendez)
   b. Restrict deductions for royalties paid to untaxed offshore affiliates (Multistate Tax Commission, Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses, 2006)
      i. For example, disallow deductions unless the effective tax rate of the recipient is greater than, for example, 20% and the recipient does not pay out the amount to another related party that is taxable at a lower rate

II. FOREIGN TAX CREDIT AND SOURCING RULES

1. **Further limit cross-crediting**

   a. Supplement the two existing foreign tax credit limitation baskets (passive and general income) with additional baskets (for example, subpart F income and dividends from non-controlled foreign corporations)
      i. Alternatively, use per-country baskets (S.727 (112th Congress), Bipartisan Fairness and Tax Simplification Act of 2011, sponsored by Sens. Wyden and Coats)

b. Treat rents and royalties received from a related party as falling in passive income basket for foreign tax credits (Congressional Research Service, "Tax Havens: International Tax Avoidance and Evasion," 2013)
c. For purposes of determining the foreign tax credit from foreign subsidiaries of U.S. multinationals, treat all foreign subsidiaries as one corporation (FY2014 Administration Budget Proposals; estimated in 2012 to raise $57 billion over 10 years)
d. Strengthen the dual capacity rules (FY2014 Administration Budget Proposals; estimated in 2012 to raise $10 billion over 10 years; S.727 (112th Congress), Bipartisan Fairness and Tax Simplification Act of 2011, sponsored by Sens. Wyden and Coats; S.307 (113th Congress), Close Big Oil Tax Loopholes Act, sponsored by Sen. Menendez)

2. Improve the sourcing of income rules

a. Accelerate adoption of worldwide allocation of interest expense (currently effective in 2021)
    i. Could also repeal fair-market-value method of interest expense apportionment (H.R.4238 (102nd Congress), A bill to amend the Internal Revenue Code to more fairly apportion interest expense between domestic and foreign sources, sponsored by Rep. Schulze and others)
b. Replace title-passage rule for source of income from sales of inventory with a place-of-business rule (Fleming, Peroni, and Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty," 2012)
c. Expand the scope of the rules limiting the creation of foreign-source income upon U.S. taxpayer elections (FY2014 Administration Budget Proposals; estimated in 2012 to raise $1 billion over 10 years)

III. OTHER INTERNATIONAL BUSINESS REFORMS

1. Repeal DISC provision (H.R.3970 (110th Congress), Tax Reduction and Reform Act of 2007, sponsored by Rep. Rangel)

2. **Reform passive foreign investment company (PFIC) rules** (NY State Bar Association, PFIC Reform Recommendations, Tax Notes Today, 1993)

    a. Annual recognition of gain or loss on marketable PFIC stock
    b. For non-marketable stock, impose a small tax on the amount invested in the stock (H.R.8000 (88th Congress), The Interest Equalization Tax Act of 1963, sponsored by Rep. Mills)

3. **Reform effectively connected income rules** (Lokken, "Income Effectively Connected with U.S. Trade or Business: A Survey and Appraisal," Taxes, 2008)

    a. Narrow circumstances under which a foreign individual or corporation is considered to be engaged in a U.S. trade or business through its agents
    b. Only treat income from sales of goods as effectively connected to a U.S. trade or business to the extent that the sales are attributable to a fixed place of business in the U.S.

IV. NON-RESIDENT U.S. CITIZENS

1. **Provide an election to citizens who are long-term nonresident citizens to be taxed as nonresident aliens if they meet certain conditions** (Schneider, "The End of Taxation Without End: A New Tax Regime for U.S. Expatriates," 2013; similar to the law in Canada)

    a. Require a minimum period of residence abroad
    b. Impose an exit tax on electing taxpayers where deemed to sell all assets at the time of election

2. **Repeal the foreign-earned income exclusion** (H.R.2 (108th Congress), Jobs and Growth Tax Relief and Reconciliation Act of 2003, sponsored by Rep. Thomas)

NON-INCOME TAX ISSUES AND RELATED REFORMS

Senate Finance Committee Staff Tax Reform Options for Discussion

June 20, 2013

This document is the last in a series of ten papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The federal tax code includes a number of taxes in addition to the individual and corporate income taxes, some of which are used to fund specific programs. These non-income taxes include employment taxes (such as the taxes for Social Security and Medicare), wealth transfer taxes (such as the estate and gift taxes), and a variety of excise taxes. As illustrated in the following table, together these non-income taxes raise almost as much revenue as the individual and corporate income taxes. The overwhelming portion of non-income tax revenue is derived from employment taxes.

Federal Receipts by Source, 2012 (Billions $)

Individual Income Taxes	1,132
Social Insurance and Retirement Receipts	845
Corporate Income Taxes	242
Miscellaneous Receipts	107
Excise Taxes	79
Customs Duties and Fees	30
Estate and Gift Taxes	14
Total Receipts	**2,450**

Tax reform provides an opportunity to review the federal tax system comprehensively, looking at possible improvements through changes in non-income taxes as well as the income tax. The following are some potential broad principles for reform in this area:

- Simplify the law in order to reduce the cost to businesses and individuals of complying with the tax code
- Ensure that the overall federal tax system is fair, while minimizing the negative effect of taxes on economic growth
- Carefully consider whether and how non-income tax measures should account for any positive or negative externalities

Some specific concerns about the tax system that may be addressed, at least in part, through non-income tax measures, include the following:

- **Effect of the tax system on economic disparities:** Some argue our existing payroll and wealth transfer tax rules help to perpetuate the growing gap between the wealthy and those who are not wealthy. For example, they point to the regressivity of the payroll tax and the income tax exclusion for income that is inherited. Others argue that the tax system as a whole is not a significant cause of increasing wealth disparities and should not be used to reduce these disparities because the tax code is already very progressive.

- **Failure to account for the costs of harmful externalities:** Some argue that revenue is best raised by taxing economic activity that has a harmful effect to the extent that the costs of addressing the harm is not reflected in market prices. They argue that it would help the economy to reduce existing taxes by the amount raised by new taxes on activities producing costly negative externalities, such as activities that expose the economy to systemic financial risks. Others point out that measuring and quantifying

those externalities is challenging. They also argue that it is not appropriate for the tax code to attempt to shape behavior.

- **Effect of taxes on economic growth:** Some argue that broad-based consumption taxes are more efficient than broad-based income taxes because the former eliminates taxes on savings. For example, one study found that a broad-based consumption tax could increase gross domestic product by more than 9 percent in the long run, but this version of a consumption tax would be less progressive than the income tax and would not include transition relief for retirees. Others argue that broad-based income taxes can generate comparable gains in economic growth, and that broad-based consumption taxes are no more efficient if they are structured to avoid raising taxes on low- and middle-income households or on older generations.

REFORM OPTIONS

I. EMPLOYMENT TAXES

Under current law, employees and their employers, as well as the self-employed, pay taxes that fund Social Security and Medicare. The taxes on employees and employers are called FICA (for the Federal Insurance Contributions Act). The taxes on self-employed individuals, such as independent contractors, sole proprietors, and partners, are called SECA (for the Self-Employment Contributions Act). Together, FICA and SECA, along with the railroad retirement tax and the Federal unemployment tax, are called employment or payroll taxes.

The employee portion of the FICA tax has two components. The first is the old-age, survivors, and disability insurance component (called OASDI or the Social Security tax), which is 6.2% on wages up to $113,700 in 2013. The threshold of $113,700 is called the "Social Security taxable maximum" (or "wage cap") and is indexed for average-wage inflation. The Social Security tax is used to fund benefits that rise with the amount of taxes paid but not proportionately. The second portion of FICA is the Medicare or hospital insurance component (called the HI or Medicare tax), which is 1.45% on all wages. The employee portion of the Medicare tax (not the employer portion) is increased by 0.9 percent on wages over $200,000 for single filers and $250,000 for joint filers. The employer withholds these amounts from an employee's wages, and in addition to the employee's portion, the employer pays an equal amount in FICA tax on the employee's wages.

Similarly, the SECA tax has two components. The Social Security tax rate is 12.4% on self-employment income up to $113,700. The Medicare tax rate is 2.9% on all self-employment income, with an additional 0.9% tax on self-employment income over $200,000 for single filers and $250,000 for joint filers. In calculating self-employment income, a self-employed individual can deduct 7.65% of earnings, which is intended to mirror the fact that employers can deduct the portion of the FICA tax that they pay on their employees' wages.

Although not an employment tax, the Affordable Care Act established a net investment income tax on high income individuals. The tax applies at a rate of 3.8 percent to certain net investment income of individuals above $200,000 for single filers and $250,000 for joint filers.

Employers also must pay a Federal unemployment insurance employment tax (called FUTA for the Federal Unemployment Tax Act) of 0.6% of each employee's wages up to $7,000 (there is no employee portion to the FUTA tax), which is equivalent to $42 per employee per year. The FUTA tax is used to fund federal and state unemployment insurance administrative costs, as well as the federal share of the Extended Benefit (EB) program, loans to insolvent state unemployment compensation accounts, and state employment services.

Some Social Security benefits are subject to Federal income taxes. Individuals generally must pay income tax on part of their Social Security benefits if their income exceeds $25,000 for single filers and $32,000 for joint filers.

A number of employment tax options have been considered in previous papers. For example, the Types of Income and Business Entities option paper contained proposals to reform the treatment of S corporation income received in whole or in part in exchange for services. This section only includes options that were not covered in the other options papers.

1. Increase FICA and SECA taxes

a. Eliminate the Social Security taxable wage cap (S.567 (113th Congress), Strengthening Social Security Act, sponsored by Sen. Harkin; S.500 (113th Congress), Keeping Our Social Security Promises Act, sponsored by Sen. Sanders; Roosevelt Institute, "Budget for a Millennial America," 2011; Testimony of Stephen Goss before the Ways and Means Committee Subcommittee on Social Security, June 23, 2011)
    i. Apply the Social Security tax to all earnings above the current taxable wage cap, either at the full 12.4% or a lower rate

b. Gradually increase the Social Security taxable wage cap over time so that the Social Security tax eventually covers 90% of national wages (National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010); Domenici and Rivlin, Bipartisan Policy Center, "Restoring America's Future," November 2010)
c. Apply the Medicare tax to all income (wages, investment income and business income) (Burman and Johnson, "A Proposal to Finance Long-Term Care Services through Medicare with an Income Tax Surcharge," Urban Institute, 2007)
    i. Could be combined with repeal of the net investment income tax
d. Increase the Medicare tax rate by, for example, one percentage point (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, estimated in 2011 to raise $651 billion over 10 years)
e. Apply the FICA and SECA taxes to certain employee benefits such as:
    i. Employer-provided health coverage (Domenici and Rivlin, Bipartisan Policy Center, "Restoring America's Future," November 2010; Testimony of Stephen Goss before the Ways and Means Committee Subcommittee on Social Security, June 23, 2011)
    ii. Employer contributions to retirement plans (Testimony of William Gale before the Senate Finance Committee, September 15, 2011)
    iii. Contributions to cafeteria plans and qualified transportation fringe benefits (Weller, "Building It Up, Not Tearing It Down: A Progressive Approach to Strengthening Social Security," Center for American Progress, December 2010; Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

2. Eliminate or reduce the FICA and SECA taxes

a. Reduce the employee portion, or both the employee and employer portions, of the Social Security tax rate by, for example, 2 percentage points (Douthat, "Our Enemy, The Payroll Tax," New York Times, November 24, 2012; S.381 (102nd Congress), Economic Growth and Jobs Creation Act of 1991, sponsored by Sen. Wallop)
b. Eliminate employment taxes for individuals age 62 or older (Antos et al., "Fiscal Solutions: A Balanced Plan for Fiscal Stability and Growth," American Enterprise Institute, May 2011)
c. Eliminate the FICA tax (McGrattan and Prescott, "On Financing Retirement with an Aging Population," Federal Reserve Bank of Minneapolis Staff Report 472, October 1, 2012)

3. **Make the Social Security tax less regressive**

    a. Lower the Social Security tax rate on wages below the taxable wage cap (Warshawski, "A Pro-Growth and Progressive Social Security Reform Proposal," Tax Notes, 2009)

4. **Eliminate employment tax exclusions for certain categories of workers**

    a. Extend Social Security and Medicare taxes to all state and local government employees (S.727 (112th Congress), Bipartisan Tax Fairness and Simplification Act, sponsored by Sens. Wyden, Coats, and Begich; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, estimated in 2011 to raise about $96 billion over 10 years)
    b. Eliminate the exclusion from Social Security Tax for foreign workers with short-term U.S. visas (North, "How Employers Cheat America's Aging by Hiring Foreign Workers," Center for Immigration Studies, 2012)

5. **Simplify, clarify, and make fairer the FICA and SECA tax rules**

    a. Modify the income tax deduction for self-employment taxes to make SECA taxes economically equivalent to FICA taxes (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)
        i. Under current law, in calculating self-employment income, a self-employed individual can deduct 7.65% of earnings
        ii. This is intended to mirror the fact that employers can deduct the portion of the FICA tax that they pay on their employees' wages, but the current deduction is larger than necessary to provide parity with FICA
    b. Permit the IRS to require prospective reclassification of certain workers as employees (FY14 Administration Budget Proposal; estimated in 2013 to raise $9 billion over 10 years; S.2145 (112th Congress), Fair Playing Field Act, sponsored by Sen. Kerry)
    c. Treat certified professional employer organizations as employers for employment tax purposes (S.479 (113th Congress), Small Business Efficiency Act, sponsored by Sens. Grassley and Nelson)

6. **Reform the income tax treatment of Social Security and Medicare benefits**

    a. Reduce or eliminate the percentage of Social Security benefits that are subject to income tax, for example, by including no more than 50% of benefits in income (S.514 (108th Congress), Social Security Benefits Tax Relief Act of 2003, sponsored by Sen. Bunning)
    b. Provide an income tax deduction for Social Security taxes paid by employees and self-employed individuals (S.A.4008 to S.Con.Res.57 (104th Congress), sponsored by Sen. Ashcroft)
    c. Tax high-income households on part of the value of Medicare benefits (Penner, "Tax Benefits for the Elderly," Urban Institute, 2000)

7. **Improve the solvency of the state unemployment insurance trust funds**

    a. Reinstate and make permanent the 0.2 percent FUTA surtax (FY14 Administration Budget Proposal; estimated in 2013 to raise about $15 billion over 10 years)
    b. Raise the FUTA wage base and lower the net federal FUTA tax rate (low wage base States would need to increase their taxable wage base to conform to the new FUTA wage base) (FY14 Administration Budget Proposal, estimated in 2013 to raise about $51 billion over 10 years)

II. WEALTH TRANSFER TAXES

General Rules

Under current law, individuals do not pay income tax on the value of gifts or bequests received. Instead, a wealth transfer tax may be imposed on the donor of a lifetime gift or on transfers from a decedent's estate.

The wealth transfer tax system has three components: the estate tax, the gift tax, and the generation-skipping transfer (GST) tax. The estate tax is a tax imposed on certain transfers at death. The gift tax is imposed on certain lifetime transfers. The generation-skipping transfer tax is imposed on transfers to someone who is more than one generation younger than the donor (sometimes called a "skip person"). The generation-skipping transfer tax is intended to prevent the inequity of taxing wealth transfers that are made directly to, for example, a

grandchild, less heavily than the same transfer if it is first made to the child who in turn transfers the funds to the grandchild.

Currently, the estate tax, generation-skipping transfer tax, and gift tax all have a top tax rate of 40%. Over their lifetime, for 2013, individuals effectively can exclude up to $5.25 million ($10.5 million for couples) in gifts and bequests they make. As a result, no tax applies until the sum of all gifts made during life and all bequests exceeds these exemption amounts, which are indexed for inflation.

Under current law, there is a separate annual exclusion from the gift tax for small gifts. In 2013, the first $14,000 ($28,000 for couples) in gifts to a given individual are not subject to the gift tax and do not count against the lifetime exemption. These amounts are also indexed for inflation.

Basis

There are special rules to calculate the "basis" of non-cash property received by gift or inheritance. Basis generally is the amount that a taxpayer uses to determine how much gain or loss the taxpayer must recognize for tax purposes when they sell an asset. Typically, basis is the amount the taxpayer paid for an asset. In the case of a gift made during the lifetime of the donor, the recipient's basis in the property received generally is the same as it was in the hands of the donor, known as "carryover basis." As a result, any gain that had not been recognized by the donor is preserved and will be taken into account when the gift is disposed of by the donee. If the donor's basis exceeds the fair market value of the property at the time of the gift, the donee's basis is limited to the fair market value for purposes of determining any subsequent loss on sale of the property.

In contrast, in the case of a bequest, the recipient's basis generally is the fair market value of the property at the time of the decedent's death. This is known as "stepped-up basis," and generally means that any gain or loss not recognized by the decedent will never be taxed. The law does not require that the recipient's basis be the same as the value reported for estate tax purposes.

Valuation

There are also special rules for valuing certain types of property. Generally, the value of property for wealth transfer tax purposes is the fair market value of the property as of the date of a gift or the decedent's death. However, taxpayers may discount the value of closely-held businesses, either if there is no active market for the business, or if the donor is transferring a

minority interest in the business (sometimes referred to as "lack-of-marketability" and "minority" valuation discounts).

Taxpayers may also discount the value of real estate if it is being used in a trade or business. Fair market value typically is determined based on the highest and best use of land, regardless of the current or intended use. The "special use" valuation rules allow taxpayers who are using land in a business (such as farming) to value it based on the assumption that it will continue to be used in that business, subject to certain limits. For example, taxpayers cannot discount the value of such land by more than about $1 million. The tax benefit may also be recaptured if the heir sells the land or ceases to use it for the business within 10 years of receipt.

Liquidity

To address liquidity concerns, current law allows taxpayers to defer payment of any estate tax due on the transfer of a closely-held, active business for up to five years (called the "deferral period"), and then pay the tax, with interest, in equal, annual installments over the following ten years. In order to qualify for deferral, the closely-held active business must be worth more than 35% of the value of the estate. Under this installment provision, the law imposes a lien on the estate assets for the ten year period immediately following the decedent's death, expiring five years before the due date of the final installment payment.

Trusts

Wealth transfers can be accomplished through gifts or bequests to trusts, as well as through direct transfers. When a donor transfers wealth through a trust, the rules regarding how much tax is due, when it is due, and who is liable are complex and differ based on the type of trust.

One estate planning tool is known as a "grantor trust." A grantor trust is a trust where the person transferring wealth (the "grantor") is still treated as the owner for federal income tax purposes. Taxpayers sometimes structure these trusts so that the trust assets are treated as separate from the grantor for wealth transfer tax purposes. The gift tax then applies at the time the assets are transferred into the trust. This structure ensures that any subsequent appreciation on the trust assets is not subject to the estate or gift taxes, while allowing the grantor to pay the income taxes of the trust.

Another estate planning tool is known as a grantor retained annuity trust ("GRAT"). In a GRAT, the grantor is entitled to annuity payments from the trust assets, while other beneficiaries are entitled to any trust assets that remain thereafter (called a "remainder interest"). The gift tax applies to the value of the remainder interest of the beneficiaries at the time the assets are

transferred into the trust. The value of this remainder interest is calculated using certain valuation rules in the tax code. If the beneficiaries ultimately receive more than the assumed value of the remainder interest at the time of the initial transfer, there are no further wealth transfer tax consequences. In some cases, taxpayers structure GRATs so that the remainder interest of the beneficiaries is treated as having zero value, meaning that any assets that the beneficiaries ultimately receive escape wealth transfer tax entirely.

Another type of trust is known as a Crummey trust. Crummey trusts are structured to allow the transferred assets to qualify for the $14,000 annual gift tax exclusion. In general, a gift only qualifies for the annual gift tax exclusion if the beneficiary has the right to use the property immediately (called a "present interest"). To ensure that a transfer qualifies for the exclusion, a grantor may give beneficiaries a temporary right to withdraw property. This temporary right is generally known as a "Crummey power" and has been found to satisfy the present interest requirement.

Transfers between spouses generally are not subject to wealth transfer taxes because there is an unlimited marital deduction. Trusts are sometimes used to preserve the marital deduction in situations where a surviving spouse receives less-than-full ownership of the assets. In a Qualified Terminal Interest Property Trust (or "QTIP" trust), the surviving spouse generally is given an income interest for life, with the remainder of the assets then passing to other beneficiaries. The remaining property is then included in the surviving spouse's estate upon death. If the surviving spouse disposes of part of the QTIP property (including the income interest), sometimes this triggers unintended gift taxes because the partial disposition is treated as a disposition of the entire property.

A final estate planning trust is known as a perpetual dynasty trust. In this type of trust, the grantor allocates their generation-skipping transfer tax exemption to a trust with an unlimited duration. This structure ensures that any subsequent income and appreciation on the trust assets are not subject to wealth transfer taxes.

State Wealth Transfer Taxes

Through 2004, taxpayers could claim a credit for the amount of the state wealth transfer taxes paid for purposes of calculating their federal wealth transfer tax liability. Since 2005, taxpayers have been able to deduct wealth transfer taxes paid to the states instead.

Community Property

In community property states, a surviving spouse may pay less income tax when selling inherited community property than a surviving spouse in a non-community-property state. This is because the basis in the entire property (both spouses' shares) is stepped up to fair market value at the death of the first spouse in a community property state. In non-community-property states, however, only the basis in the deceased spouse's portion of jointly owned property is stepped up to fair market value. Options for reform in this area include the following.

1. **Repeal the estate and generation-skipping transfer taxes**

    a. Repeal the estate and generation skipping transfer taxes, retain stepped-up basis for bequests, and retain the gift tax with a $5 million lifetime exemption and a 35% top tax rate (S.1183 (113th Congress), Death Tax Repeal Act of 2013, sponsored by Sens. Thune and others)

2. **Replace the wealth transfer system with an alternative wealth transfer tax system**

    a. Require the beneficiary to include gifts and bequests in income for purposes of the income tax, sometimes referred to as "income inclusion" (Testimony of Joseph Dodge before the Finance Committee, March 12, 2008)
    b. Impose an inheritance tax on the recipient of a gift or bequest (sometimes referred to as an "accessions tax"), whereby a tax is imposed on the recipient of a gift or bequest (Testimony of David Duff before the Finance Committee, March 12, 2008; Testimony of Joseph Dodge before the Finance Committee, March 12, 2008)
    c. Repeal stepped-up basis and carryover basis and tax accrued gains on gifts and bequests at the time of transfer, possibly with carryover basis or an exclusion for gains on certain assets (Dodge, "A Deemed Realization Approach is Superior to Carryover Basis (And Avoids Most of the Problems of the Estate and Gift Tax)," Tax Law Review, 2001; similar to the law in Canada)
    d. Options (a) through (c) could be coupled with an annual or lifetime exemption for a certain dollar amount of inherited assets or gains on inherited assets

3. Modify the tax rates and exemptions

a. Decrease the exemption and increase the rate for the estate, gift, and generation skipping transfer taxes
   i. Return the wealth transfer tax rates to 2009 levels, setting the top rate at 45% and the exemption at $3.5 million for the estate and GST taxes and $1 million for the gift tax (FY14 Administration Budget Proposal; estimated in 2013 to raise $69 billion over 10 years)
   ii. Return the top tax rate and exemption amount to pre-2001 levels, setting the top rate at 55%, the exemption at $1 million, and reinstating the 5% surtax on estates above $10 million (H.R.3467 (112th Congress), Sensible Estate Tax Act of 2011, sponsored by Reps. McDermott and Rangel)

b. Return the top tax rate to 35% for all wealth transfer taxes (House Amendment to Senate Amendment to H.J.Res.66 (112th Congress), the Permanent Tax Relief for Families and Small Business Act of 2012, sponsored by Rep. Boehner)

4. Reform and simplify the current wealth transfer tax system

a. Harmonize the tax rules for gifts and bequests
   i. Apply the same effective tax rate on gifts and bequests (Joulfaian, "Choosing Between an Income Tax and a Wealth Transfer Tax," National Tax Journal, 2001)
      1. Under current law, the estate tax applies to the amount transferred including the tax due, while the gift tax applies to the amount transferred excluding the amount due
      2. For example, if a donor has $140 to transfer above the lifetime exemption, the tax due under the estate tax would be $56, while the tax due under the gift tax would be $40
   ii. Apply carryover basis to bequests (Joulfaian, "Choosing Between an Income Tax and a Wealth Transfer Tax," National Tax Journal, 2001)
   iii. Require that the basis in property in the hands of the recipient for income tax purposes can be no greater than the value of the property for wealth transfer tax purposes, and require reporting to the beneficiary and the IRS (FY14 Administration Budget Proposal; estimated in 2013 to raise about $2 billion over 10 years)

b. Reform the rules for valuing assets

i. Repeal the dollar limitation on special use valuation discounts (Letter from the American Farm Bureau Federation to Ways and Means Small Business/Passthroughs Working Group , April 2, 2013)

ii. Disallow lack-of-marketability and minority valuation discounts (H.R.3467 (112th Congress), Sensible Estate Tax Act of 2011, sponsored by Reps. McDermott and Rangel)

1. For transfers of an interest in an entity which is not actively traded:

I. Treat non-business assets (e.g., passive investments) as transferred directly to the beneficiary with no valuation discounts

II. Exclude such non-business assets in determining the value of the interest in the entity

2. Disallow minority discounts where the beneficiary and family members control the entity

c. Reform the installment and deferred payment rules

i. Extend the estate tax lien to cover the entire deferral period under the installment rules (FY14 Administration Budget Proposal; estimated in 2013 to raise less than $1 billion over 10 years)

ii. Defer tax due on transfer of farm land until either the farm is sold or transferred outside of the family, or until the family stops materially participating in the farming business (S.A.4727 to H.R. 4853, The Middle Class Tax Cut Act of 2010, introduced by Sen. Baucus; S.3664 (111th Congress), Family Farm Estate Tax Deferral Act of 2010, sponsored by Sens. Feinstein, Bennet, Crapo, Nelson, and others)

iii. Repeal rules allowing for an exclusion for conservation easements, special use valuation discounts for real property, and installment payments; replace with a broader system allowing estates to defer estate tax payments for all assets until sold by heir (American Institute of CPAs, "Study on Reform of Estate and Gift Tax System," February 2001; Letter from Estate Tax Coalition to Ways and Means Committee Tax Working Group on Pensions and Retirement, April 15, 2013)

1. Limit use by adjusting interest rates and deferral periods

d. Reform rules relating to trusts

i. Limit perpetual dynasty trusts

1. Limit allocations of GST exemptions to dynasty trusts to a skip of one generation (Joint Committee on Taxation, "Taxation of

Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform," April 2008)

2. Require the GST tax exclusion allocated to a dynasty trust to expire after 90 years (FY14 Administration Budget Proposal; estimated in 2013 to have a negligible budgetary effect over 10 years)
3. Deny the GST tax exemption prospectively, unless the trust terminates within one of the following periods: (1) 21 years after the death of a life in being; (2) 90 years after creation; or (3) after the death of the last living beneficiary who is no more than two generations younger than the donor (Waggoner, "Effectively Curbing the GST Exemption for Perpetual Trusts," University of Michigan Program in Law and Economics, June 2012)

ii. Require that a GRAT have a minimum term of 10 years and eliminate zeroed-out GRATs (FY14 Administration Budget Proposal; estimated in 2013 to raise $3 billion over ten years)

iii. For grantor trusts, treat any property received by the trust as a result of a transaction between the grantor and the trust as part of the grantor's estate, subject to the gift tax if the grantor ceases to own the trust while alive, and as a gift if distributed to another person during the grantor's life (FY14 Administration Budget Proposal; estimated in 2013 to raise $3 billion over 10 years)

iv. Limit the use of Crummey powers to qualify a transfer for the gift tax annual exclusion (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

v. Modify the QTIP rules (Klomparens and deLeo, "Proposed Changes to Internal Revenue Code Section 2519," State Bar of California Taxation Section, 2011)

1. When surviving spouse partially disposes of QTIP property, apply the gift tax to the partial disposition rather than the entire property
2. Allow a good faith appraisal so that surviving spouse is not penalized by unintended gift taxes should assets in trust be sold for below fair market value

e. Allow donors to elect to pre-pay the estate tax at a discounted tax rate rather than the estate paying at the individual's death (Sen. Cantwell, "Statement on Estate Tax," February 2010)

5. Miscellaneous simplification reforms

a. Change the unified credit to a unified exemption (American College of Trust and Estate Counsel, "Talking points for Congressional Staff Members," October 2012)
b. Do not require that the election for portability be made on an estate tax return (The American College of Trust and Estate Counsel, "ACTEC Comments on Notice 2011-82," October 2011)
    i. Current law allows the decedent's estate to elect to transfer any unused exemption to the surviving spouse by filing an estate tax return, which is known as portability
c. Expand extensions to more missed elections (The American College of Trust and Estate Counsel, "Comments regarding…Elections and Certain Late Qualified Revocable Trust Elections," April 2013)
    i. Generally, the tax law requires that elections be made by certain deadlines, although the IRS may grant extensions for making an election
d. Treat the basis of community property in the same manner as property held in non-community property states by allowing the transfer of community property to receive a step-up in basis for only the decedent's half of community property, instead of a full step-up in basis for the decedent's half and the surviving spouse's half (Ware, "Section 1014(b)(6) and the Boundaries of Community Property," Nevada Law Journal, 2005)
e. Convert the deduction for state estate taxes into a credit (Thiessen, "The Death of State Death Tax Credit: Can it be Resuscitated?" Marquette Elder's Advisor, 2009)

III. EXCISE TAXES

A number of excise tax options have been considered in previous papers. For example, the Infrastructure, Energy, and Natural Resources options paper contained proposals to reform excise taxes used to fund infrastructure-related trust funds and to establish a tax on carbon emissions. The Economic Security options paper contained proposals to modify the excise taxes on medical devices and high-premium health insurance plans, and to establish or modify excise taxes on sugary beverages, tobacco, alcohol, and marijuana. The Tax-Exempt Organizations and Charitable Giving options paper included proposals establishing or modifying excise taxes on certain tax-exempt organizations and private foundations. This section only includes options that were not covered in the other options papers.

1. **Introduce a securities transactions excise tax** (Tobin, "On the Efficiency of the Financial System," Lloyds Bank Review, 1984)

    a. Tax financial instruments (including stocks, bonds, and other debts) at a rate of, for example, 0.03% of their fair market value where the security is either cleared through a U.S. exchange or where any party to the security is a U.S. person (S.1787 (112th Congress), Wall Street Trading and Speculators Tax Act, sponsored by Sen. Harkin; estimated in 2011 to raise $352 billion over 9 years)
    b. Tax stock transactions at, for example, 0.1% of their fair market value, and tax derivatives and similar instruments at, for example, 0.01% of the value of the instruments involved in the transaction (H.R.4191 (111th Congress), Let Wall Street Pay for the Restoration of Main Street Act, sponsored by Rep. Defazio; similar to the European Commission scheme being implemented in certain EU countries)

2. **Prohibit the Treasury Department from assisting foreign governments in enforcing taxes on securities transactions occurring on a U.S. exchange** (Protect American Investment Act of 2013, to be introduced by Sen. Roberts)
    a. Treasury does not currently assist in collecting securities transactions taxes of other countries

3. **Impose a levy on large financial institutions**

    a. Could be based on covered liabilities (FY14 Administration Budget Proposal; estimated in 2013 to raise $49 billion over 10 years)
        i. Covered liabilities is risk-weighted assets of the firm less its Tier 1 capital, FDIC insured deposits, and certain loans to small business
        ii. Reduced rate applies to more stable sources of funding, including long-term liabilities
        iii. Applies only to U.S. based financial firms with at least $50 billion in assets and to U.S. subsidiaries of foreign based financial firms with assets in excess of $50 billion.
    b. Could be based on cash flows (Shaviro, "The Financial Transactions Tax vs. The Financial Activities Tax," Tax Notes, March 2012)

4. **Enact or increase sin taxes**

    a. Increase excise taxes on sales of guns and ammunition (H.R.793 (113th Congress), Firearm Safety and Buyback Grant Act of 2013, sponsored by Rep. L. Sanchez; Dwyer, "If Guns Do Not Kill, Tax the Bullets," New York Times, August 9, 2012)
    b. Tax video slot machines at, for example, $1,000 per machine (Cook County Illinois Board President Budget Proposal, 2012)
    c. Impose a 5% tax on all wagering (H.R.2800 (104th Congress), Education Trust Fund Act, sponsored by Rep. Fields of Louisiana)
    d. Legalize and tax all drugs (Miron and Waldock, "The Budgetary Impact of Ending Drug Prohibition," Cato Institute, 2010)

5. **Repeal all sin taxes**

    a. Repealed taxes would include taxes on cigarettes, alcoholic beverages, gasoline, and bullets (Williams and Crist, "Taxing Sin," Mercatus on Policy, 2009)

6. **Enact a tax on the value of land** (Testimony of James K. Galbraith to the Finance Committee, March 8, 2011; Friedman, Interview, the Times Herald, December 1, 1978)

7. **Modify the rum excise tax transfer ("cover-over") to the United States Virgin Islands and Puerto Rico, and limit the total amount of direct or indirect government assistance to rum producers** (S.986, (112th Congress), Investing in U.S. Territories, Not Corporations Act, sponsored by Sens. Menendez, Nelson and Rubio)

IV. CONSUMPTION TAXES

A consumption tax is a tax on income devoted to consumption, essentially taxing consumers on the money they spend on goods and services. In comparing income and consumption taxes, the most important difference is that a consumption tax eliminates the tax on savings. Consumption taxes generally place greater overall burdens on lower-income households than do income taxes because lower-income households tend to save less of their income than higher-income households do. There are, however, ways to design a consumption tax to mitigate the impact on lower-income households.

Consumption taxes commonly take the form of a retail sales tax or a value added tax (VAT). A retail sales tax is a consumption tax levied only at a single stage of production, the retail stage.

The retailer collects a specific percentage markup in the retail price of a good or service, which is then remitted to the tax authorities. Most states have a retail sales tax; however, most countries with consumption taxes, have implemented a VAT instead. Retail sales taxes create enforcement issues because taxpayers can avoid the tax by claiming to be a wholesaler.

A VAT is a tax on exchanges. A VAT is a tax, levied at each stage of production, on the value that businesses add to the goods and services they purchase from other businesses. The value added by a business is the difference between a business' sales and purchases of inputs from other businesses. A VAT is collected by each business at every stage of production. It differs from a retail sales tax only in the sense that is collected in parts along the chain of production rather than all at once at the retail level.

There are two traditional methods of calculating a VAT: the credit-invoice method and the subtraction method. Under the credit-invoice method, businesses apply the VAT rate to their sales but claim a credit for VAT paid on purchases of inputs from other businesses (shown on purchase invoices). The difference between the VAT collected on sales and the credit for VAT paid on input purchases is remitted by the business to the government. Under the subtraction method, a business subtracts the full amount of the cost of their inputs (including the VAT) from their sales, and then pays the VAT on the difference. To the extent the VAT would not be collected on exports, some have raised concerns over whether the subtraction method would be compliant with World Trade Organization rules with respect to that treatment. Most countries use the credit-invoice method. Options for reform in this area include the following.

1. **Enact a consumption tax, while preserving the income tax and employment taxes** (Domenici and Rivlin, "Restoring America's Future," Bipartisan Policy Center, November 2010; Sen. Cardin, "Deficit Medicine: A VAT Tax and a Line Item Veto," Baltimore Sun, 1989; Testimony of Pamela F. Olson before the Finance Committee, March 1, 2011; Testimony of Fred T. Goldberg, Jr. before the Finance Committee, March 1, 2011; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, broad-based VAT estimated in 2011 to raise $2,500 billion over 10 years at a 5% rate)

    a. Implement a flat-rate VAT on most sales of goods and services (similar to the law in Canada)

        i. Design issues include:

            1. Whether to adopt the credit-invoice method or subtraction method

2. Whether to "border adjust" by applying to imports but not to exports
3. Whether to exempt certain goods and services, such as food staples and health care, or provide a refundable tax credit, in order to reduce the burden on low- and middle-income households and retired and disabled individuals
4. Whether to make corresponding adjustments to the Social Security tax and benefit rules

ii. Could be coordinated with state and local sales taxes, as with the Canadian system (Stuckey and Yong, "A Primer on Federal Consumption Taxes," Library of Parliament Research Publications, 2011)

b. Implement a progressive consumption tax (Andrews, "A Supplemental Personal Expenditure Tax," What Should be Taxed: Income or Expenditure?, 1980; Grinberg, "Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method System," National Tax Journal, 2006)
   i. Allow individuals to immediately deduct all net amounts saved or invested, while disallowing all deductions for interest
   ii. Enact a credit-invoice method VAT coupled with a business-level credit for the VAT due on wages paid
      1. Tax all compensation of individuals above a large standard deduction amount at progressive tax rates

c. Could use revenue from the consumption tax to reduce proportion of households or businesses that owe income tax or the amount of income tax owed (Graetz, "100 Million Unnecessary Returns," Yale University Press, 2010)
   i. Implement a flat-rate VAT of, for example, 15%
   ii. Increase the income tax standard deduction to, for example, $100,000, and tax individual income above that amount at graduated rates up to, for example, 25%
   iii. Reduce the corporate income tax rate to, for example, 15%
   iv. Replace the earned income tax credit with payroll tax offsets, designed to offset the VAT's burdens on low-income families

d. Could use revenue from the consumption tax to reduce income tax or FICA and SECA tax burdens (Viard, "Responding to VAT: Concurrent Tax and Social Security Reforms," American Enterprise Institute, 2011; Toder and Rosenberg, "Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes," Tax Policy Center, 2010)

2. Replace the income tax with a consumption tax

a. Replace the income tax with a national retail sales tax coupled with a rebate for low-income families (sometimes referred to as the "Fair Tax") (S.122 (113th Congress) The Fair Tax Act of 2013, sponsored by Sen. Chambliss)
   i. Implement retail sales tax of, for example, 30% tax on nearly all goods and services
   ii. Provide all families a monthly "pre-bate" of, for example, $500 for a two adult household with one child

b. Replace the income tax with a multi-stage, progressive consumption tax, such as a VAT
   i. Enact a subtraction method VAT but allow businesses to deduct wages and other compensation for services
      1. Tax all compensation of individuals above a large standard deduction amount at a flat tax rate of, for example, 20%, sometimes referred to as the "Flat Tax" (S.1040, 110th Congress, Tax Simplification Act of 2007, sponsored by Sen. Shelby; Hall and Rabushka, The Flat Tax, 2007)
      2. Tax all compensation of individuals above a large standard deduction amount at progressive tax rates, sometimes referred to as the "X-Tax" (Bradford, "The X-Tax in the World Economy," 2004; Carroll and Viard, "Progressive Consumption Taxation: The X-Tax Revisited," 2012)

   ii. Enact a credit-invoice method VAT coupled with a business-level credit for the VAT due on wages paid (Grinberg, "Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method," National Tax Journal, 2006)
      1. Tax all compensation of individuals above a large standard deduction amount at progressive tax rates

c. Convert the income tax into a cash-flow consumption tax (S.722 (104th Congress) USA Tax Act of 1995, sponsored by Sens. Domenici and Nunn; Andrews, "A Consumption-Type or Cash Flow Personal income Tax," Harvard Law Review, 1974; McCaffrey, Fair Not Flat: How to Make the Tax System Simpler and Better, 2002)
   i. Allow individuals and businesses to immediately deduct all net amounts saved or invested
   ii. All net income that is not saved is taxed as ordinary income

    iii. Disallow all deductions for interest
    iv. Could apply to individuals and businesses or to individuals alone

d. Could couple consumption tax with a constitutional restriction to increasing the consumption tax without 2/3 of each chamber of Congress voting for such an increase (Section 13, Article 11 of the Constitution of the State of South Dakota)

3. Replace employment taxes with a consumption tax

a. Replace the Medicare tax with a VAT (Viard, "Responding to VAT: Concurrent Tax and Social Security Reforms," American Enterprise Institute, 2011; Burman, "A Blueprint for Tax Reform and Health Reform," Virginia Tax Review, 2008)

SIMPLIFYING THE TAX SYSTEM FOR FAMILIES AND BUSINESSES

Senate Finance Committee Staff Tax Reform Options for Discussion

March 21, 2013

This document is the first in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The Internal Revenue Service (IRS) is charged with the critically important responsibility of administering our tax system. The IRS mission statement reads as follows: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all." The IRS is expected to carry out this mission effectively and efficiently, while minimizing the burdens of tax compliance. There are many complex and interrelated components to tax administration that the IRS must manage, including information processing, receipt and disbursement of funds, enforcement activities, and providing taxpayer assistance.

Simplifying our tax laws and reforming the administration of the law is an opportunity to ease the burdens of compliance on taxpayers. It is also an opportunity to allow the IRS to accomplish its mission more fairly, efficiently, and effectively. Following are some potential broad principles for reform in this area:

- Reduce the cost to taxpayers of complying with the tax code
- Improve the ability of the IRS to administer the tax law efficiently
- Reduce tax evasion and inadvertent mistakes
- Provide taxpayers with better service
- Protect taxpayers from identify theft and privacy invasions
- Ensure that all taxpayers are treated fairly and similarly situated taxpayers are treated similarly

Some specific concerns about tax administration today include the following:

- **Overall Complexity**: Taxpayers find the tax system to be too complex, time consuming, and costly. Taxpayers are so overwhelmed by the tax code that about 59% now pay preparers to file for them, and another 30% use tax preparation software to streamline the filing process. In 2010, individuals and businesses paid $168 billion to comply with the tax code, which equals 15% of total income tax receipts. Critics argue this complexity obscures understanding of the tax code and undercuts voluntary compliance.

- **Taxpayer Identity Theft**: Criminals use a variety of methods to obtain taxpayer identification numbers and then file fraudulent tax returns to collect tax refunds. Victims of tax identity theft experience substantial difficulty correcting fraudulent returns and obtaining tax refunds that they are rightfully owed.

- **The Tax Gap**: The tax gap is the difference between what taxpayers pay to the IRS and what they owe under the law. The most recent IRS net tax gap estimate (based on 2006 data) is $385 billion. This is an underpayment of approximately 14% of the estimated correct tax liability. The tax gap is the result of both conscious tax evasion and inadvertent mistakes, many of which are due to the complexity of the tax code. The amount of information reporting, and whether or not withholding is required, can have a significant effect on the tax gap. The IRS estimates that when income is subject to substantial information reporting and withholding (such as wages and salaries), about

These option papers include ideas from across the spectrum and, as such, do not necessarily have the endorsement of either the Chairman or Ranking Member

99% of the income is reported to the IRS. When income is subject to some information reporting and no withholding (such as capital gains and alimony income), about 89% of the income is reported. When income is subject to neither information reporting nor withholding (such as nonfarm, sole proprietor income and royalties), only about 44% of the income is reported.

- **Problematic Filing Schedule**: Many note that the current filing deadlines do not permit the IRS or taxpayers to access third-party information on a timely basis. As a result, the current system limits the information at taxpayers' disposal to file accurate and timely returns, and it limits the ability of the IRS to verify information on taxpayers' returns before refunds are paid.

- **Regulation of Tax Return Preparers**: Due to tax law complexity, taxpayers increasingly rely on third parties to prepare their returns, thereby increasing their exposure to preparer misconduct or error. In 2011, the IRS started regulating tax return preparers by requiring registration and imposing minimum competency standards. The District Court of Washington, DC recently ruled (Loving, No. 12-385 (D.D.C. 1/18/13)) that the IRS lacks the authority to regulate tax return preparers. If the IRS does not prevail in its appeal of the *Loving* case, it will lose an important tool to increase tax compliance and protect taxpayers from unethical tax return preparers.

REFORM OPTIONS

I. COLLECTION AND ENFORCEMENT

1. Reduce tax fraud and taxpayer identify theft

a. Limit access to personal identifying information, such as SSNs of recently deceased individuals on SSA's Death Master File (National Taxpayer Advocate, 2011 Annual Report to Congress, Volume 1; S.3432, Identity Theft and Tax Fraud Prevention Act, sponsored by Sen. Bill Nelson; H.R.3475, Keeping IDs Safe Act of 2011, sponsored by Rep. Johnson)
b. Partner with third parties, such as banks and bank card providers, to share successful practices to combat identity theft and tax fraud (Network Branded

Prepaid Card Association testimony at Senate Finance Subcommittee Meeting on Tax Fraud, March 20, 2012)

c. Improve information sharing with federal, state, and local law enforcement (S.3432, Identity Theft and Tax Fraud Prevention Act, sponsored by Sen. Bill Nelson)

2. Reduce the tax gap

a. Restructure and simplify the penalty system to improve voluntary compliance and ease the administrative burden of the system, for example, by consolidating similar penalties (National Taxpayer Advocate, 2008 Annual Report to Congress)
b. Improve, automate, and enhance information reporting by third parties to the IRS (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper; GAO-12-651T) through, for example, the following reforms:
    i. Require information reporting by federal, state, and local governments on non-wage payments for property or services (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
    ii. Improve information reporting by financial institutions on unreported and underreported financial accounts (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
    iii. Require additional information on home mortgage interest (GAO-09-769; GAO Testimony at the Senate Finance Committee on March 26, 2012; S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
    iv. Clarify information on Schedule C (GAO-09-238)
    v. Require e-filing for certain employee benefit plan information returns and reports (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
    vi. Require life insurance companies to report certain transactions, including sales, transfers, and benefits (S.2048, A bill to… clarify the tax treatment of certain life insurance contract transactions…, sponsored by Sen. Casey)
c. Limit the ability of seriously delinquent taxpayers to avoid paying taxes through, for example, the following reforms:
    i. Revoke or deny passports of seriously delinquent taxpayers (Moving Ahead for Progress in the 21st Century Act, 2012; score: $743 million; provision was marked up and approved by the Finance Committee on February 7, 2012)

ii. Require Medicare contractors to screen prospective Medicare providers for unpaid taxes, including obtaining consent from providers to disclose federal tax debts (GAO-08-618)
iii. Authorize a 100% continuous levy on payment to Medicare providers and suppliers who neglect or refuse to pay taxes (S.3457, Veterans Jobs Corps Act of 2012, sponsored by Sen. Bill Nelson)

d. Ensure that the IRS has authority to oversee paid preparers by providing clear statutory authority for the IRS to regulate tax return preparers if the IRS loses its appeal in the *Loving* case
e. Enhance privacy protections in IRS whistleblower programs by, for example, requiring the redaction of third-party return information in administrative and judicial proceedings for a whistleblower claim (National Taxpayer Advocate, 2011 Annual Report to Congress, Volume One)
f. Adopt policies to increase voluntary compliance based on behavioral economics findings, such as communications strategies emphasizing social norms (National Taxpayer Advocate, 2007 Annual Report to Congress, Volume II; Behavioural Evidence & Insight Team, United Kingdom)
g. Provide IRS with additional resources to carry out enforcement, enhance taxpayer services, and modernize their information technology systems (GAO-12-651T; The President's Budget for Fiscal Year 2013; estimated $20 billion in net non-scoreable budgetary savings) (Note: This is outside of the Finance Committee's jurisdiction)

3. Improve the taxpayer experience in IRS audit and collection procedures

a. Increase collection of delinquent tax liabilities by making it easier for taxpayers to structure payment plans with the IRS
b. Provide waivers for user fees when installment agreements use automated withdrawals (H.R.1528, the Tax Administration Good Government Act, sponsored by Rep. Rob Portman)
c. Codify and improve the correspondence audit process (National Taxpayer Advocate, 2011 Annual Report to Congress, Volume 2; Testimony of Troy Lewis at the Senate Finance Committee, April 26, 2012)
d. Expand the IRS virtual service pilot program (Virtual Face-to-Face Audits, National Taxpayer Advocate Blog; Testimony from Teresa Thompson at the Senate Finance Committee, April 26, 2012)

These option papers include ideas from across the spectrum and, as such, do not necessarily have the endorsement of either the Chairman or Ranking Member

e. Strengthen taxpayer privacy rights, particularly regarding digital information (GAO-13-350)

II. FILING PROCESS

1. Enable the IRS to verify information on taxpayer returns against third-party information as returns are processed

a. Establish a system of filing deadlines that ensures timely receipt of reliable third-party information by taxpayers and the IRS, for example by changing due dates for returns (S.420, Tax Return Due Date Simplification and Modernization Act of 2013, sponsored by Sen. Enzi; American Institute of Certified Public Accountants (AICPA), AICPA Recommends Change to Return Due Dates; Testimony of Troy Lewis at the Senate Finance Committee, April 26, 2012)
b. Improve the process for filing information returns with the IRS by, for example, requiring e-filing information returns directly to the IRS instead of or at the same time as the Social Security Administration (other suggestions listed in GAO Testimony to the Senate Finance Committee on June 28, 2011)
c. Provide the IRS with additional time to process returns more accurately by, for example, extending the refund-due date beyond which the IRS must pay interest from 45 days to 60 days
d. Authorize the IRS to use external data (e.g., the National Directory of New Hires) to verify employment (S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sen. Wyden; S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
e. Require that electronically-prepared paper returns printed and sent to the IRS include a 2D barcode, which is required by many states, to increase the speed and accuracy of paper return processing (GAO-08-38, S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)

These option papers include ideas from across the spectrum and, as such, do not necessarily have the endorsement of either the Chairman or Ranking Member

2. **Reduce compliance costs by having the IRS fill out simple returns for taxpayers**

    a. For taxpayers with relatively simple returns, require the IRS to pre-fill the returns with information it has received from third parties and preliminarily calculate tax liability; taxpayer could either accept and sign this return or make needed changes (California's "Ready Return" program; President's Economic Recovery Advisory Board, 2010; Tax Policy Center, Ways to Improve the Tax System: Return-Free Filing)

III. SIMPLIFICATION

Well-coordinated, comprehensive tax reform will reduce the need for many complex provisions to limit the ability of some taxpayers to benefit from certain deductions, credits, exemptions, and exclusions. The following general elements of our current tax system could be repealed or greatly simplified as part of comprehensive tax reform. Subsequent papers will compile simplification options in specific areas.

1. **Repeal provisions that require taxpayers to calculate their tax liability multiple times** (JCS-3-01; S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sen. Wyden; Bowles-Simpson Zero Plan Chairmen's Mark; Rivlin-Domenici Bipartisan Policy Center Tax Reform Plan; President's Economic Recovery Advisory Board, 2010; Tax Foundation, The Economic and Policy Implications of Repealing the Corporate Alternative Minimum Tax)

    a. Repeal the individual Alternative Minimum Tax (AMT)
    b. Repeal the personal exemption phase-out (PEP)
    c. Repeal the phase-out of itemized deductions (Pease)
    d. Repeal the corporate AMT

2. **Simplify and conform definitions in tax code**

    a. Establish uniform definitions of terms such as "qualifying child", "modified adjusted gross income", and "related party" (Tax Policy Center, Incremental Reform: What are Ten Ways to Simplify the Tax System?)

These option papers include ideas from across the spectrum and, as such, do not necessarily have the endorsement of either the Chairman or Ranking Member

3. **Identify and remove deadwood provisions**

    a. Repeal provisions that are no longer necessary including, for example, the more than 100 "deadwood" provisions identified by JCT (JCS-3-01)

IV. MISCELLANEOUS

1. **Update the taxpayers' bill of rights**

    a. Codify and update taxpayer bill of rights that would explicitly detail the rights and responsibilities of taxpayers, such as the right to confidentiality and the obligation to pay taxes on time (National Taxpayer Advocate, 2011 Annual Report to Congress)

2. **Improve Tax Court operations and protect taxpayer rights before courts**

    a. Improve taxpayer access to judicial forums, for example, by changing filing periods, venue appeals, and evidence rules; strengthen judicial administration and accountability, for example, through changes to rules governing judicial appointments, tenure, and the retirement system (US Tax Court Legislative Proposals Submitted to the 113th Congress)

3. **Improve government transparency by providing taxpayers with a receipt for taxes paid**

    a. Require the IRS to provide every taxpayer who files an individual tax return with an itemized receipt; the receipt could show the taxpayer's average tax rate, marginal tax rate, the value of the tax expenditures they claim, and/or an allocation of their tax payments to the major spending categories in the federal budget (S.437, Taxpayer Receipt Act of 2011, sponsored by Sen. Bill Nelson; H.R.1527, sponsored by Rep. Quigley; Third Way, Idea Brief: A Taxpayer Receipt)

These option papers include ideas from across the spectrum and, as such, do not necessarily have the endorsement of either the Chairman or Ranking Member

4. Streamline JCT's review of large refunds

a. Simplify the process for JCT reviewing large refunds by, for example, raising the threshold for refunds that JCT must review above $2 million and more clearly articulating the role of JCT in the large refund review process (JCT)

These option papers include ideas from across the spectrum and, as such, do not necessarily have the endorsement of either the Chairman or Ranking Member

TAX-EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

Senate Finance Committee Staff Tax Reform Options for Discussion

June 13, 2013

This document is the ninth in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

Under current law, certain organizations that serve public interests are eligible for two main tax benefits: an exemption for their earnings from the income tax and, for a sub-set of such organizations, a deduction for donations to the organization.

Tax-exempt organizations must meet certain requirements to achieve and maintain their tax-exempt status. For example, tax-exempt organizations must be nonprofits, cannot have shareholders or owners, and generally cannot use the organization's assets to provide a benefit to a person or entity that is closely related to the organization. Most tax-exempt organizations are subject to a tax on unrelated business income for earnings not linked to their charitable mission.

The deduction for contributions is limited to donations to certain categories of organizations, such as those directed towards charitable, religious, scientific, literary or educational purposes. Organizations eligible to receive deductible contributions are sometimes referred to as "charitable" organizations, although many other types of entities, such as governmental entities and private foundations, are also eligible recipients.

Tax reform provides an opportunity to evaluate the effectiveness of charitable giving incentives and the tax benefits for organizations serving public interests. Following are several potential goals that could serve as guidelines for the Committee when reviewing the tax rules for exempt organizations and charitable contributions:

- Maximize the efficiency and effectiveness of any incentives for charitable giving that are retained or reformed
- Consider whether the availability of tax incentives for charitable giving should be broadened to more taxpayers
- More tightly align tax-exempt status with providing sufficient charitable benefits
- Closely examine the relationship between political activity and tax-exempt status
- Reconsider the extent to which tax-exempt organizations should be allowed to engage in commercial activity
- Improve the accountability and oversight of tax-exempt organizations

Some specific concerns related to the tax rules associated with tax-exempt organizations include the following:

- **Fairness:** The charitable deduction is an itemized deduction. Therefore, it is only available to the roughly one-third of taxpayers who itemize, although the standard deduction is supposed to take into account a certain amount of itemized deductions. Among taxpayers who itemize, the value of the charitable deduction is proportional to the taxpayer's income tax bracket. Because the income tax brackets are progressive, this means that higher-income individuals get a larger benefit for a contribution of the same amount. According to CBO, the charitable deduction represents 0.7% of after-tax income for the highest quintile, but only 0.1% of after-tax income for the middle quintile. Some argue that allowing taxpayers to deduct charitable giving is appropriate because the donor is giving away the entire contribution without receiving anything tangible in return. Others argue that charitable giving incentives should be the same for all taxpayers.

- **Low bang-for-the-buck:** Tax incentives in this area could potentially achieve more at a lower cost. For example, according to CBO, providing an above-the-line deduction or refundable credit for charitable contributions above a certain percentage of the donor's income could lead to greater total charitable contributions at a lower cost. Some research also suggests that "matching" a taxpayer's charitable contributions by directing the tax incentive to the charity, rather than the donor, could increase total charitable giving at less cost. But some argue that governmental gift matching programs do not work well in practice. There also are questions as to its constitutionality with respect to religious organizations. In addition, other research suggests that simply cutting the charitable deduction without other reforms would reduce charitable giving.

- **Political activity**: Some tax-exempt organizations are allowed to engage in political activities. Some argue that tax-exempt organizations should not be allowed to engage in political activities, especially campaigning for or against a particular candidate, or that they should have to disclose their donors if they do so. Others argue that tax-exempt organizations should be allowed to engage in these activities with fewer or no restrictions and should not be required to disclose their donors.

- **Sufficient charitable benefit of tax-exempt organizations:** Theoretically, nonprofit organizations are granted tax-exempt status because they provide a benefit to the public, particularly to the poor and underserved. However, organizations that do not serve the needy can often claim tax-exempt status, and some tax-exempt organizations appear to serve private interests in the same way as for-profit corporations.

- **Commercial activity**: Some tax-exempt organizations engage in commercial activities, either as part of their tax-exempt purpose or through activities unrelated to their tax-exempt purpose which are then subject to the unrelated business income tax ("UBIT"). Some are concerned that this results in unfair competition with for-profit businesses, erosion of the corporate tax base, or managers focusing too little on the tax-exempt purpose of the organization.

- **Accountability and oversight:** There are approximately 1.5 million tax-exempt organizations with $2.7 trillion in assets, and 29 different types of tax-exempt organizations. As with any large sector of the economy, there are instances of waste, fraud, and abuse. Some think more should be done to monitor charities, for example to ensure that they are not spending a large share of their donations on fundraising and large salaries for their founders.

REFORM OPTIONS

I. CHARITABLE DEDUCTION

Under current law, individuals and corporations may deduct contributions to charitable and certain other organizations for income tax purposes. Individual taxpayers may only deduct charitable contributions if they itemize rather than claiming the standard deduction. Charitable contributions are not, however, disallowed for purposes of the alternative minimum tax. In 2009, 27% of all taxpayers itemized and claimed the charitable deduction. Corporate and individual charitable giving totaled almost $300 billion in 2011.

In addition, there are limits on how much charitable contributions taxpayers may deduct as a share of their income. As illustrated in the following table, individuals may only deduct up to 50% of their adjusted gross income (AGI) for most charitable contributions, and only up to 30% of their AGI for charitable contributions of capital gain property. For private foundations and certain other organizations, individuals may only deduct up to 30% of their AGI for most contributions and up to 20% of their AGI for contributions of capital gain property. C corporations may only deduct up to 10% of their taxable income, inclusive of all types of contributions.

General Limits on Charitable Deductions for Individuals as a Share of Their Adjusted Gross Income

	Gift to Public Charity	Gift to Private Foundation
Cash	50%	30%
Ordinary Income Property	50%	30%
Capital Gain Property	30%	20%

When contributing appreciated property, taxpayers are not required to pay capital gains tax on the gain on the property. Taxpayers generally may deduct the full fair market value of donated property. However, in certain cases, taxpayers can only deduct the lesser of the fair market value of the property and their "basis" in the property (which is typically how much they paid for it). For example, taxpayers may only deduct their basis in the property if the gain would be taxed at ordinary income rates, or if the property is not related to the charitable organization's exempt purpose.

Taxpayers can only deduct contributions to a subset of tax-exempt organizations in the tax code. For example, they may deduct contributions to governmental entities, religious organizations, educational institutions, museums, and many others. They cannot deduct contributions to foreign organizations, most social welfare (501(c)(4)) organizations, labor

organizations (501(c)(5)), and chambers of commerce (501)(c)6)). According to the Joint Committee on Taxation, there are about 1.5 million tax-exempt organizations and about 1.1 million organizations eligible to receive deductible contributions (501(c)(3)). About 300,000 of these organizations are religious organizations. Some charities rely on contributions more than others. Health care and education charities rely relatively less on private giving and relatively more on fees for services, whereas religious, environmental, animal, and arts charities are relatively dependent on contributions. Others rely more on government grants for funding.

1. **Repeal the charitable contribution deduction** (Mitchell, "Should We End the Tax Deduction for Charitable Contributions?," Wall Street Journal, December 12, 2012)

2. **Fundamentally reform the charitable contribution deduction**

    a. Convert the deduction to a refundable or nonrefundable credit (Joint Committee on Taxation, "Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions," February 2013)
        i. Create a flat non-refundable credit of, for example, 12% of charitable contributions (National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," 2010)
        ii. Replace the deduction with a refundable tax credit of, for example, 25% for all taxpayers (Thiess and Fieldhouse, Our Fiscal Security, "Investing in America's Economy," 2010)
    b. Structure any charitable incentive as a "match" that is paid directly to the charity
        i. Repeal the deduction and provide charities with a matching grant in the form of a refundable credit equal to, for example, 15% of the donor's contribution (Bipartisan Policy Center, "Restoring America's Future," November 2010; Scharf and Smith, "The Price Elasticity of Charitable Giving: Does the Form of Tax Relief Matter?" Economic & Social Research Council, 2010)
        ii. This option could also be coupled with the existing deduction, although that would entail more administrative complexity (similar to the law in the U.K.)
    c. Cap the amount or value of the charitable deduction
        i. Limit the value of the deduction to, for example, 28% per dollar deducted (FY14 Administration Budget Proposal; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011)

            1. This would also be the result if the top rate were lowered (H.R.3838 (99th Congress), The Tax Reform Act of 1986, sponsored by Rep. Rostenkowski)
        ii. Implement a maximum dollar cap on all itemized deductions, including the charitable deduction, of, for example $50,000 cap on itemized deductions (Sen. Corker, Summary of the Fiscal Reform Act of 2012)
    d. Allow non-itemizers to claim the charitable contribution deduction (Testimony of Dr. Eugene Steuerle before the Committee on Ways and Means, February 14, 2013; President's Advisory Panel on Federal Tax Reform, 2005)
    e. Focus the deduction on "traditional" charities, such as churches and homeless shelters, that support the needy (Reich, "A Failure of Philanthropy," Stanford Social Innovation Review, 2005)

3. Attempt to increase the effect of charitable incentives on charitable giving

    a. Only provide tax incentives for charitable giving for contributions in excess of a certain percentage of the taxpayer's income
        i. Only allow the deduction for charitable contributions in excess of, for example, 2% of the taxpayer's adjusted gross income (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011; estimated in 2011 to raise $219 billion over 10 years)
        ii. This option could be combined with proposals to convert the deduction to a credit (National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," 2010)

4. Incrementally reform the charitable contribution deduction

    a. Simplify the deduction
        i. Repeal the limits on how much taxpayers may deduct as a share of their income (H.R.2903 (103rd Congress), To… provide that the percentage limitations on the charitable deduction shall not apply to contributions for… disaster relief, and for other purposes, sponsored by Rep. Talent)
        ii. Streamline the statutory language, clarify definitions, and remove deductions for contributions prone to abuse (Halperin, "The Charitable Deduction Section 170 Reorganized," Urban Institute, 2012)
            1. For example, include all special valuation or measurement rules in section 170(a), and repeal deduction for donations of taxidermy and certain types of inventory

2. Consolidate the limits on how much taxpayers may deduct as a share of their income for contributions of appreciated property to charities and private foundations

iii. Carve out the charitable deduction from the Pease limitation (H.R.1479 (113th Congress), To… remove the deduction for charitable contributions from the overall limitation on itemized deductions, sponsored by Rep. Sensenbrenner)

iv. Allow taxpayers to deduct charitable contributions for the previous tax year until April 15 of the following year, in order to coincide with tax filing deadlines (Testimony of Dr. Eugene Steuerle before the Committee on Ways and Means, February 14, 2013)

b. Limit deductions for non-cash contributions

i. Limit the deduction for all contributions of property to the lesser of the donor's basis in the property or the fair market value (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

ii. Allow unlimited deductions for the fair market value of all contributions of appreciated property, but require taxpayers to pay any applicable capital gains tax on the gain at the time of the contribution (Halperin, "A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains," Tax Law Review, 2002)

iii. Disallow the contribution of property unless it is of direct benefit to the charity (Colinvaux, "Charitable Contributions of Property: A Broken System Reimagined," Harvard Journal on Legislation, 2013)

iv. Limit the deduction for clothing and household items to, for example, $500 (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

v. Modify the rules regarding contributions of fractional interests in tangible personal property, including art (Association of Art Museum Directors, Submission to Ways and Means Charitable/Exempt Organization Working Groups, 2013)

vi. Allow enhanced deductions for inventory property only in response to specific requests (Kim and Hjorth, "Does Charity Begin at Home for Pharmaceutical Companies?" Tax Notes, October 2011)

c. Expand deductions for non-cash contributions

i. Allow taxpayers to sell appreciated property without recognizing gain and receive a full charitable deduction if the entire sales proceeds are

donated to a charity within 60 days of the sale (President's Advisory Panel on Federal Tax Reform, 2005)

ii. Make permanent the enhanced deduction for food inventory for all types of business entities, not just C corporations (Feeding America comments to Committee on Ways and Means working group on Charitable/Exempt organizations, submitted April 15, 2013)

iii. Increase the standard mileage rate for individual automobile use by volunteers (S.3246 (110th Congress) Fair Deal for Volunteers Act of 2008, sponsored by Sen. Grassley; S.243 (111th Congress) GIVE Act of 2009, sponsored by Sen. Cardin)

d. Disallow the charitable deduction for contributions made to support specific commercial activities

  i. Disallow the deduction for charitable contributions that are a prerequisite for purchasing tickets to sporting events (Clotfelter, "Stop the Tax Deduction for Major College Sports Programs," Washington Post, December 31, 2010)

  ii. Disallow the charitable deduction for contributions to support collegiate sports teams (Congressional Budget Office, "Tax Preferences for Collegiate Sports," 2009)

  iii. As discussed in Part II, disallow the charitable deduction as part of limiting tax-exempt status for organizations engaged in large amounts of commercial activity

e. Modify the deduction for contributions of conservation easements

  i. Repeal the deduction (Halperin, "A Better Way to Encourage Gifts of Conservation Easements," Tax Notes, July 2012)

  ii. Make permanent the expanded deduction for contributions of conservation easements (S.526 (113th Congress), The Rural Heritage Conservation Extension Act of 2013, sponsored by Sens. Baucus, Hatch, Stabenow, and others)

  iii. Replace the deduction with a refundable tax credit, capped at an overall dollar amount (Halperin, "A Better Way to Encourage Gifts of Conservation Easements," Tax Notes, July 2012)

    1. Could require a public agency, for example, the Bureau of Land Management, to allocate credits based on conservation value of the donated property

  iv. Eliminate the deduction for:

1. Personal residences (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)
2. Forgone upward development of a historic building (FY14 Administration Budget Proposal; estimated in 2013 to raise less than $1 billion over ten years)
3. Partial interests in property to be used as a golf course (FY14 Administration Budget Proposal; estimated in 2013 to raise $1 billion over ten years; S.526 (113th Congress), The Rural Heritage Conservation Extension Act of 2013, sponsored by Sens. Baucus, Hatch, Stabenow, and others)

v. Strengthen qualification requirements for organizations receiving donated conservation easements
   1. Require that the organization be certified by a public agency, for example the IRS, to receive conservation easements (Halperin, "A Better Way to Encourage Gifts of Conservation Easements," Tax Notes, July 16, 2012)
   2. Suspend a land trust's ability to accept new donations if an audit reveals repeated failures to enforce easements or an unsustainable ratio of easements held to available resources (Colinvaux, "The Conservation Easement Tax Expenditure: In Search of Conservation Value," Columbia Journal of Environmental Law, 2012)

f. Make permanent or expand tax-free distributions from individual retirement accounts (IRAs) for charitable purposes (S.557 (112th Congress), Public Good IRA Rollover Act of 2011, sponsored by Sen. Schumer)

g. Reform reporting and valuation rules
   i. Require charities to report to the IRS gifts above, for example, $600 to improve compliance (President's Advisory Panel on Federal Tax Reform, 2005)
   ii. Increase the threshold at which taxpayers are required to obtain qualified appraisals for non-cash contributions from $5,000 to, for example, $10,000 (GAO, "Burdens on Taxpayers Could Be Reduced and Selected Practices Improved," 2012)
   iii. Increase reporting requirements for enhanced deductions for inventory property (Colinvaux, "Enforcing the Enhanced Charitable Deduction," Urban Institute, 2012)

II. TAXATION OF BUSINESS ACTIVITIES OF NONPROFITS

Generally, tax-exempt organizations, including charities, must be organized for a tax-exempt purpose. As a result, these organizations are allowed to participate in other activities only to a limited extent.

Charitable and tax-exempt organizations that engage in commercial activities may be subject to tax on the income from some portion of those activities. Trade or business income that is related to exempt activities (e.g., fee-for-service revenue) is generally tax-exempt, while trade or business income that is not related to the exempt purpose is generally taxable. Most tax-exempt organizations can operate an unrelated trade or business, so long as operating the trade or business is not the organization's primary activity or a substantial part of the organization's activities. For certain types of tax-exempt organizations, investment income is also taxable. In practice, some tax-exempt organizations create complex structures to coordinate and operate trade or business activities, including but not limited to for-profit subsidiaries and joint-venture partnerships.

When a tax-exempt organization regularly carries on trade or business activities that are unrelated to its exempt purpose, the income from those activities is generally subject to the unrelated business income tax (UBIT). There are some exceptions, however. For example, dividends, interest, rents and royalties (unless derived from debt-financed property) are generally exempt from UBIT. Special rules exist for income paid to a tax-exempt organization from a controlled for-profit business.

1. **Tax all commercial activities of tax-exempt organizations** (Testimony of John D. Colombo before the Committee on Ways and Means, July 25, 2012)

2. **Revise the requirements for tax-exempt status for organizations engaged in commercial activity**

    a. Disallow tax-exempt status for certain organizations engaged in business activities, such as credit unions, nonprofit hospitals or certain types of insurance firms (Hodge, Tax Foundation, "Raising Revenue: The Least Worst Options," 2012)
    b. In the case of fee-for-service nonprofits or charities, such as nonprofit hospitals and credit counseling organizations (Colinvaux, "Charity in the 21st Century: Trending Toward Decay," Florida Tax Review, 2011):

i. Impose an affirmative requirement to provide service irrespective of ability to pay,
ii. Require a "reasonable" fee, and
iii. Require an independent governing body

c. Provide charities conducting commercial activity with more certainty of tax-exempt status
   i. Clarify that commercial activities related to a tax-exempt purpose do not jeopardize tax-exempt status (Testimony of John D. Colombo before the Committee on Ways and Means, July 25, 2012)
   ii. Clarify that charities receiving a majority of their gross income from activities related to their mission are not at risk of losing tax-exempt status (Pena and Reid, "A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities," NYU Law Review, 2001)

d. Reform hospital requirements for tax-exemption
   i. Require tax-exempt hospitals to provide a certain amount of charity care, for example 5% of operating expenses (Sen. Grassley, Tax-Exempt Hospitals: Discussion Draft, 2007)
   ii. Require joint-venture, for-profit hospitals to adopt charity care requirements (Sen. Grassley, Tax-Exempt Hospitals: Discussion Draft, 2007)

e. Reassess the treatment of tax-exempt organizations providing insurance
   i. Require that a fraternal beneficiary society, order, or association is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

3. Revise the UBIT rules for organizations engaged in commercial activity

a. Classify certain activities as unrelated to any charitable mission and therefore subject to UBIT
   i. Subject the income of university athletic programs to the UBIT (Congressional Budget Office, "Tax Preferences for Collegiate Sports," 2009)

b. Expand exemptions from UBIT
    i. Permanently extend the exemption from UBIT for exempt organizations receiving investment income from a controlling organization if such investment income is no more than the fair market value (National Automobile Dealers Association comments to Committee on Ways and Means working group on Charitable/Exempt organizations, submitted April 15, 2013)
    ii. Exempt "traditional" charities (i.e. those who mission is exclusively to serve the poor) from UBIT rules so long as all income is being used to fund the primary purpose (Kelley, "Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law," Fordham Law Review, 2005)
c. Modify the UBIT treatment of income from debt-financed activities
    i. Exempt some established employee-funded pensions (H.R.6056 (111th Congress), A bill...to treat certain employee-funded pensions...in the same manner as qualified trusts,.., sponsored by Rep. Neal)
    ii. Allow tax-exempt organizations to directly invest in debt-financed securities and commodities (including certain hedge funds and other investment funds) without incurring UBIT (H.R. 3970 (110th Congress), Tax Reduction and Reform Act of 2007, sponsored by Rep. Rangel)
    iii. Establish a "look-through" rule to address the use of foreign "blocker" corporations to avoid the rules regarding debt-financed investment income (Miller, "How US Tax Law Encourages Investment Through Tax Havens," Tax Notes, 2011)

4. Tighten rules on conversion from tax-exempt to for-profit status

Under current law, charities are allowed to reorganize as for-profit entities, when doing so may avoid federal income tax on assets that are unrelated to their charitable mission.

a. Tighten rules on conversion from tax-exempt to for-profit status, for example, by imposing a termination tax on the conversion of assets (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

5. **General reforms to tax-exempt entities**

   a. Eliminate tax-exempt status of professional sports leagues under business leagues definition (S.A.750, offered by Sen. Coburn, to S.743 (113th Congress), Marketplace Fairness Act of 2013, sponsored by Sen. Enzi)
   b. Allow mutual ditch and irrigation companies to receive a larger percentage of their income from leases and sales of certain real property without jeopardizing their tax-exempt status (S.3650 (112th Congress), Ditch and Irrigation Company Tax Reform Act, sponsored by Sen. Udall)

III. POLITICAL ACTIVITY AND LOBBYING OF TAX-EXEMPTS

Some types of tax-exempt organizations may engage in lobbying or political activities. Lobbying involves attempting to influence Members of Congress, legislative staff or senior executive staff. Political activity involves participating in or intervening in political campaigns.

Section 501(c)(3) organizations are not allowed to participate in any political activities. In addition, "no substantial part" of their activities can involve lobbying. While the definition of "no substantial part" is not entirely clear, many believe that no more than approximately 5% to 10% of a 501(c)(3)'s activities may be comprised of lobbying. There is, however, a safe harbor where such organizations are allowed to spend up to $1 million on lobbying activities. Section 501(c)(3) organizations are required to apply for exempt status. Donors to section 501(c)(3) public charities are not made public.

Section 501(c)(4) organizations (social welfare), (c)(5) organizations (labor unions) and (c)(6) organizations (trade associations) may participate in some political activity as long as that activity is not the organization's primary activity. These groups can engage in unlimited lobbying activities as long as they relate to the organization's tax-exempt purpose. These organizations may, but are not required to, apply for exempt status, and donors to these organizations are not made public.

Section 527 organizations are political organizations and may engage in unlimited political activities. At formation, these groups must give notice to the IRS within 24 hours. These organizations are required to make public donors making contributions of more than $200 per person, per calendar year.

1. **Limit political activity of 501(c)(4), (c)(5) and (c)(6) organizations**

    a. Limit the amount of political election activity that such organizations may engage in to, for example, 10% of expenditures (Congressional Letter to the Commissioner of the IRS, sent by Sen. Schumer and others, March 2012; Colvin, "Political Tax Law After Citizens United: A Time For Reform," Tax Analysts, 2010)
    b. Require that such organizations disclose the amount and percentage of their total annual expenditures that go to influencing federal, state and local elections (Congressional Letter to the Commissioner of the IRS, sent by Sen. Schumer and others, March 2012; New York Office of the Attorney General, "A.G. Schneiderman Adopts New Disclosure Requirements For Nonprofits That Engage In Electioneering," June 2013)

2. **Change the categories of tax-exempt organizations that may engage in political activities**

    a. Create a new category for tax-exempt organizations engaged primarily in political activities (Aprill, "Regulating the Political Speech of Non Charitable Exempt Organizations After Citizens United," Election Law Journal, 2011)
        i. Add new requirements for 501(c)(4), (c)(5), and (c)(6) organizations regarding lobbying and political activity and clarify existing rules through statute
        ii. Require 501c(4), (c)(5), and (c)(6) organizations to file a notice of application for exemption within a specified period
        iii. Increase public disclosure of contributors to 501c(4), (c)(5), (c)(6) organizations and the new category of politically active tax-exempt organizations
        iv. Tax political activities of 501c(4), (c)(5), and (c)(6) organizations and the new category of politically active tax-exempt organizations, regardless of whether the organization has investment income
    b. Eliminate 501(c)(4) organizations, but allow them to reapply for tax-exempt status under another existing category (Colombo, "Do Away With Them," New York Times, May 15, 2013)
    c. Require an organization involved in any political campaigning to be a 527 organization (Aprill, "Create a New Category," New York Times, May 15, 2013)
    d. Deny tax-exempt status to section 501(c)(5) labor unions if members' dues are used by a union in political campaign (S.A.416, offered by Sen. Bob Dole to H.R.13270, The Tax Reform Act of 1969)

3. Reform reporting and disclosure rules

a. Require certain reporting by tax-exempt organizations involved in Federal election-related activity (S.791 (113th Congress), The Follow the Money Act of 2013, sponsored by Sens. Wyden and Murkowski)
   i. Impose an excise tax on tax-exempt organizations for failing to report to the Federal Election Commission certain contributions or expenditures
      1. Would apply to contributions or expenditures used to influence a nomination or election of an individual to any federal office
      2. Alternatively, revoke tax-exempt status for tax-exempt organizations failing to report such contributions and expenditures
   ii. Require 527 organizations to file with the Federal Election Commission
   iii. Deny business expense deductions for election-related activity expenditures by businesses that fail to report such expenditures to the Federal Election Commission
b. Ensure that members of tax-exempt organizations, including 501(c)(4), 501(c)(5), and 501(c)(6) organizations, are notified of the portion of their dues used for political and lobbying activities (S.65 (105th Congress), A bill to… ensure that members of tax-exempt organizations are notified of the portion of their dues used for political and lobbying activities, sponsored by Sen. Hatch)
c. Require any tax-exempt organization supporting political activity to disclose donors (Mayer, "Require Disclosure of Their Donors," New York Times, May 15, 2013)
d. Increase thresholds for reporting requirements for section 527 organizations (Fei, "Less is More: A Proposal For Tax Simplification for Exempt Organizations' Political and Lobbying Activities," Nonprofit Law Matters, May 2013)
e. Tighten the rules relating to 501(c)(4), (c)(5) and (c)(6) organizations (Mancino,"Don't Eliminate Them," New York Times, May 15, 2013)
   i. Require such organizations to apply for tax-exempt status
   ii. Require such organizations to disclose all donors, similar to private foundations who are required to make public donors
   iii. Apply the gift tax to donations given to such organizations

4. Clarify that payments to 501(c)(4) organizations are excluded from the gift tax (Fei, "Less is More: A Proposal For Tax Simplification for Exempt Organizations' Political and Lobbying Activities," Nonprofit Law Matters, May 2013)

5. **Expand the prohibition on 501(c)(4) organizations engaging in lobbying from receiving any federal funds to include contracts** (S.A.1842, offered by Sen. Craig to S.1060 (104th Congress), The Lobbying Disclosure Act of 1995, sponsored by Sen. Levin)

IV. BROAD TAX-EXEMPT ISSUES

Tax-exempt organizations must meet certain standards to maintain exempt status. Most tax-exempts are required to file annual information returns reporting gross income, disbursements and other information.

Generally, these organizations are subject to prohibitions against private inurement and private benefit. Under the private inurement prohibition, organizations are not allowed to use the organization's assets for the benefit of a person or entity with a close relationship to the organization. In addition, 501(c)(3) organizations are prohibited from serving private interests unless the private benefit is extremely small. For 501(c)(3) and (c)(4) organizations, an excise tax is imposed when the organization provides a closely related party with an "excess benefit".

Certain rules apply based on the type of charity. Charities (i.e., organizations eligible to receive deductible contributions) are broken down into two categories: public charities and private foundations. An organization is treated as a private foundation unless it meets one of several tests for the more favorable public charity status. To be a public charity, an organization must either be: (1) a certain kind of organization, such as a church, hospital, or governmental unit, (2) broadly supported by the public, (3) a supporting organization, or (4) a public safety organization. An organization is broadly supported by the public if at least one-third of its funding comes from the public or governmental, or from the public and revenue from activities related to the charitable purpose. Private foundations generally have one donor or a small group of donors.

Private foundations are subject to several requirements and operational restrictions that do not apply to public charities. For example, private foundations must distribute 5% of their assets each year. They also must pay a 2% tax on their net investment income each year. This tax is lowered to 1% if the foundation meets distribution requirements. In addition, the IRS and the private foundation must make public the foundation's donors.

1. **Reform the taxation of private foundations**

    a. Replace the two rates of net investment income excise tax on private foundations with a single tax rate of, for example, 1.40% (FY14 Administration Budget Proposal; estimated in 2013 to cost $54 million over 10 years; S.593 (112th Congress), To amend the Internal Revenue Code to modify the tax rate for excise tax on investment income of private foundations, sponsored by Sen. Schumer)

    b. Relax the rule prohibiting private foundations from owning more than 20% of a for-profit corporation if the foundation acquires the business through gift or bequest, the foundation is independent of the donor's family, and the for-profit corporation distributes all of its net profits to the foundation (S.3377 (112th Congress), Philanthropic Enterprise Act of 2012, sponsored by Sens. Lieberman and Snowe)

2. **Reform the taxation of endowments**

    a. Require tax-exempt organizations with endowments to spend an amount equal to at least their ten-year average compounded rate of return on their endowment minus the inflation rate minus 1 percentage point (Vedder, Center for College Affordability and Productivity, "Federal Tax Policy Regarding Universities: Endowments and Beyond," 2008)

    b. Require tax-exempt organizations with endowments to distribute at least, for example, 5% of the endowment's value each year (Testimony of Lynne Munson before the Finance Committee, July 25, 2012)

3. **Ensure that donor-advised funds and supporting organizations are directing resources for charitable purposes in a timely fashion**

    Under current law, donor advised funds (DAFs) and supporting organizations are public charities that often have some donor involvement similar to private foundations. An individual may make an irrevocable gift to a DAF and receive the charitable contribution deduction. The fund then makes grants to charities on the advice of the individual donor. Supporting organizations are charities that support other exempt organizations, usually other public charities.

    a. Impose a minimum payout requirement of, for example, 5% (Finance Committee discussion draft on proposals for reforms and best practices in the area of tax-

exempt organizations, 2004; Hussey, "Avoiding Misuse of Donor Advised Funds," Cleveland State Law Review, 2010)

b. Require that all assets be distributed within a specified time frame of, for example, seven years (Madoff, "Tax Write-Off Now, Charity Later," New York Times, November 21, 2011)

4. Limit executive compensation by tax-exempt organizations

a. Further define what constitutes a private benefit as a result of charitable activities by, for example, tightening rules for revenue generated in coordination with for-profit partnerships (Testimony of John D. Colombo before the Committee on Ways and Means, July 25, 2012)
b. Modify the standard under the section 4958 excess benefit provision to apply a "reason to know" standard and replace the rebuttable presumption rule with a minimum due diligence requirement. Apply an excise tax at the entity level. Require disclosure of compensation studies. (Sen. Grassley, "Grassley Releases Review of Tax Issues Raised by Media-Based Ministries," 2011; Sen. Grassley, Amendment #F-8 to the American Healthy Futures Act, during mark-up of what would become the Patient Protection and Affordable Care Act)

5. Reform reporting requirements

Under current law, most tax-exempt organizations are required to make public their annual information reporting document on the Form 990. Tax-exempts are not required to make public the form where they disclose information about their commercial business unrelated to their mission, which is called the Form 990-T.

a. Require tax-exempt organizations to make public their Form 990-Ts (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)
b. Require electronic filing for all 990 forms (Center on Nonprofits and Philanthropy (and others), "Statement submitted to the Committee on Ways and Means," July 25, 2012)
c. Allow charities with up to $1 million in gross receipts to file a simpler form than the Form 990 (Testimony of Eve Borenstein before the Committee on Ways and Means, July 25, 2012)

d. Require an abbreviated IRS reporting requirement or a requirement to alert the IRS of an organization's intent to claim church status (Finance Committee staff memorandum to Sen. Grassley, "Review of Media-Based Ministries," January 2011)

6. **Develop enforcement methods other than revocation of tax-exempt status as the only penalty for noncompliance** (Finance Committee staff memorandum to Sen. Grassley, "Review of Media-Based Ministries," January 2011)

TYPES OF INCOME AND BUSINESS ENTITIES

Senate Finance Committee Staff Tax Reform Options for Discussion

June 6, 2013

This document is the eighth in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT LAW

Individual Income Taxes

Under current law, individuals are subject to tax on all income received unless the income is specifically excluded from tax. However, different types of income may be taxed at different income tax rates. There are generally three types of income: ordinary income, short-term capital gains and long-term capital gains. Ordinary income includes wages, interest, rents, and royalties and is taxed at rates ranging from 10% to 39.6%. Short-term capital gains are gains on "capital assets" held for one year or less and are taxed at the same rates as ordinary income. Long-term capital gains are gains on capital assets held for more than a year and are generally taxed at preferential rates, ranging from 0% to 20%. In addition, qualified dividend income is taxed at the same preferential rates as long-term capital gains. Finally, net investment income (such as interest, dividends, and capital gains) in excess of $200,000 ($250,000 for joint filers) is taxed at an additional 3.8%. This tax applies to some but not all passthrough business income.

The statutory rates on these different types of income are summarized in the following table.

Type of Income	Tax Rate Bracket						
Wages and salaries	10%	15%	25%	28%	33%	35%	39.6%
Interest, non-qualified dividends, rents, royalties, and short-term capital gains	10%	15%	25%	28%	33%	35%	39.6%
Long-term capital gains	0%	0%	15%	15%	15%	15%	20%
Qualified dividends	0%	0%	15%	15%	15%	15%	20%

Note: The effective marginal rates on different types of income may differ from these statutory rates due to various phase-outs and special provisions like Pease. Also, this chart does not reflect the 3.8% net investment income tax or payroll taxes.

The definition of different categories of income also affects taxpayers in other ways. For example, capital losses are deductible against capital gains, but can only be used to offset $3,000 of ordinary income every year. Unused capital losses may be carried forward.

Business Income Taxes

The income tax treatment of business earnings depends on what kind of entity the business elects to be for tax purposes. Business entities are generally formed under state law, with the most common forms being corporations, partnerships and limited liability companies. In most cases, businesses can elect to be taxed as either a separate entity (i.e., a C corporation) or on a passthrough basis (e.g., a partnership or an S corporation). However, most publicly-traded businesses must pay tax as C corporations.

- **C corporations**: C corporations are subject to the corporate income tax at rates ranging from 15% to 35%. Shareholders also pay tax on dividends they receive from C corporations. As a result, the earnings of a C corporation are subject to two levels of tax: once at the corporate level and a second time at the shareholder level. If a C corporation retains its earnings instead of paying them out as dividends, its stock typically appreciates and its shareholders effectively pay tax on these "retained" earnings when selling their shares at a gain.

  Although the earnings of a C corporation are subject to two levels of tax, in many cases, only a single level of tax or no tax is actually imposed on the earnings. For example, C corporation earnings paid out as interest to creditors are subject to only a single level of tax. The creditor pays tax on the income. But the corporation deducts the interest thereby avoiding tax at the corporate level. Similarly, corporate income distributed as a

dividend to tax-exempt shareholders (for example, pension plans) is, in essence, taxed only at the corporate level. The corporation cannot deduct the dividend it pays but its tax-exempt shareholders do not pay tax on their dividend income. Meanwhile, corporate earnings paid out as interest to tax-exempt lenders are not subject to any tax. The corporation deducts the interest, and its tax-exempt lenders are not taxed on their interest income.

- **Passthroughs**: Unlike C corporations, passthrough businesses are not subject to the corporate income tax. Instead, the owners of the business pay tax annually at individual income tax rates on all of the business's income, even if the business does not distribute its earnings. There are three types of businesses taxed on a passthrough basis: sole proprietorships, S corporations and partnerships. In the case of a sole proprietorship (a business that is owned by one individual), the owner pays tax on all of the business's profits as earned. S corporation shareholders pay tax on their pro rata share of the S corporation's income, gains, deductions and losses. In contrast, partners generally pay tax on their share of the partnership's income, gains, deductions, and losses according to the terms of the partnership agreement. However, there are limits on how the partnership agreement can allocate income, gains, deductions and losses for tax purposes to prevent abuse.

- **Other entities:** A third category of business is taxed under a hybrid system where the business is taxed at the entity level but receives a deduction for dividends paid to its shareholders. The owners of these businesses pay tax on dividends they receive from the business at ordinary income rates. This category includes mutual funds (also known as regulated investment companies, or RICs) and real estate investment trusts (REITs). In practice, these businesses pay little to no tax at the entity level because they distribute most of their earnings each year as dividends. In this way, these entities are taxed similarly to passthroughs—their earnings are generally only taxed at the investor level at ordinary income rates. To qualify for this tax treatment, however, the business must fulfill certain requirements regarding the types of investments, the diversity of owners, and the distribution of earnings. Other entities, such as real estate mortgage investment conduits (REMICs), cooperatives, trusts, and some industries (e.g., life insurance), have their own unique rules for taxing business income.

Over time, the relative tax rates on corporate income and passthrough income have varied. Historically, the top individual income tax rate (and thus, the top passthrough income tax rate) was significantly higher than the top corporate tax rate. As a result, many times closely-held businesses would be structured as C corporations to take advantage of lower rates. From 2003

until 2012, the top individual and corporate tax rates were the same. As a result, the earnings of C corporations were generally taxed at higher rates than the earnings of passthroughs when both the corporate and investor-level taxes were taken into account. Today, the top individual tax rate is higher than the top corporate tax rate.

Payroll Taxes

In addition to income taxes, individuals are subject to payroll taxes on much of their income. The combined employer and employee payroll tax rate is 15.3% on the first $113,700 of compensation (indexed annually), including self-employment income. Compensation between $113,700 and $200,000 ($250,000 for joint filers) is taxed at a rate of 2.9%, and compensation above those amounts is taxed at a rate of 3.8%. The $200,000 and $250,000 thresholds are not indexed for inflation.

Payroll taxes apply differently to different types of passthrough business income. For partnerships, general partners owe payroll tax on their share of the partnership's income at the rates for compensation. All partners owe payroll tax on guaranteed payments they receive for their services. In contrast, limited partners do not owe payroll tax on their share of the partnership's income. For S corporations, shareholders owe payroll tax on any wages they receive from the corporation. But S corporation shareholders do not owe payroll tax on their share of the S corporation's income.

The following table summarizes the statutory payroll tax rates for different types of income.

Types of Income	Social Security Tax	HI (Medicare) Tax
Wages, self-employment income and guaranteed payments to partners	12.4% on income up to $113,700	2.9% on income up to $200,000 for single filers ($250,000 for joint filers); 3.8% on income above
General partner's share of partnership income	12.4% on income up to $113,700	2.9% on income up to $200,000 for single filers ($250,000 for joint filers); 3.8% on income above
Limited partner's share of partnership income	None	None
S corporation shareholder's share of S corporation income	None	None

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

Tax reform provides an opportunity to rationalize the patchwork of inconsistent rules regarding the taxation of income, investments, and tax structures. Although competing goals for tax reform often point to conflicting solutions, following are some potential broad principles for reform in this area:

- Simplify the law in order to reduce the cost to businesses and individuals of complying with the tax code
- Make the tax code more neutral by reducing or eliminating differences in overall tax burdens across different types of entities, owners, and income
- Reduce or eliminate differences in the tax treatment of debt and equity

Some specific concerns about the taxation of income and business entities include the following:

- **Overall complexity:** The different treatment of various types of income and business entities is confusing for taxpayers and lacks coherence. Some business earnings are subject to two levels of income tax, while others are not. Some types of income are eligible for preferential rates, while others are not. Some types of passthrough income are subject to the payroll tax, while some are exempt. Partially as a result of this complexity, individuals and businesses spend over 6 billion hours a year to comply with the tax code according to the National Taxpayer Advocate. If tax compliance were an industry, it would be one of the largest in the U.S., requiring 3 million full-time workers.

- **Differences in the treatment of different types of business entities:** A general goal in tax policy is that similarly situated taxpayers should be taxed in a similar manner. However, different types of entities often pay tax at very different rates. For example, the earnings of a C corporation are subject to two levels of tax, while a single level of tax applies to the earnings of passthrough businesses. As discussed, this does not necessarily mean that the earnings of C corporations are taxed more heavily than the earnings of passthrough businesses. The individual and corporate income taxes have different rate structures and, in some cases, only a single level of tax or no tax is actually imposed on the earnings of a C corporation or passthrough business. But the tax rate on business earnings does vary significantly depending on whether it is a C corporation or passthrough, how it is financed, and who its

investors are. According to a 2005 CBO report, the effective tax rate on corporate investment was 6 percentage points higher than similar non-corporate investment.

Some believe that a business's earnings should be taxed at the same rate regardless of whether it is a C corporation or pass-through, a goal that some refer to as "integration" of the individual and corporate tax systems. Doing so would treat C corporations and passthroughs more neutrally. It would also treat decisions by businesses about whether to finance with debt rather than equity, or to retain earnings rather than distributing earnings, more neutrally. Others believe that certain businesses should pay tax at higher rates, for example, if the business is accessing public equity markets.

- **Tax bias on debt or equity financing**: The current tax system generally taxes equity-financed corporate earnings more heavily than debt-financed corporate earnings because corporations can deduct interest payments but not dividend payments. According to the same 2005 CBO report, the effective tax rate on debt-financed corporate investment was -6%, while the effective tax rate on equity-financed corporate investment was 36%. Some are concerned that the bias between debt and equity financing creates risk in the economy and may hinder economic growth.

- **Lock-in incentives:** Corporations generally have an incentive to retain earnings, rather than distributing earnings through dividends. Retaining earnings allows shareholders to avoid the investor-level tax until they sell their shares. In addition, investors have the incentive to hold appreciated assets rather than sell in order to avoid paying immediate tax on the gain. These twin incentives are sometimes referred to as "lock-in." Some believe lock-in incentives reduce investment in new, higher-producing assets and, as a result, hamper economic growth. Others believe that non-tax incentives may mitigate or cancel out these tax incentives.

- **Fairness**: Income from services is taxed at higher rates than some income from capital. For example, wages are taxed at a top income tax rate of 39.6% whereas long-term capital gains are taxed at a top income tax rate of 20%. Some argue that all income should be taxed the same, for example, because the different tax treatment for income from services and capital income creates economic distortions, complicates the tax code, and provides room for gaming. Others argue that capital income should be taxed at a lower rate than income from services, for example, in order to reduce the bias against savings, mitigate incentives to hold on to underperforming assets, and account for the effects of inflation.

- **Distinguishing service income from capital income:** When owners of a privately-held business contribute both services and capital to the business, it can sometimes be difficult to distinguish how much of their income from the business is attributable to each. This matters because compensation for services is taxed as ordinary income and subject to payroll taxes, while income from capital may be taxed at the preferential capital gains rates and subject to little or no payroll taxes. The different tax treatment can create incentives for taxpayers to characterize income from services as investment income. For example, some S corporation shareholders may avoid payroll taxes if they characterize income they receive from the business as returns on their capital investments instead of reasonable compensation. According to GAO, in 2003 to 2004, about 13% of S corporations did not pay adequate wages to shareholders for their labor.

- **Differences in the treatment of economically-similar financial instruments:** The taxation of financial instruments is based on the categorization of the instrument. As the financial products markets have evolved, tax categories of financial instruments have been created or expanded. These rules often depend on a particular description of the economic characteristics of an instrument. Financial instruments may be structured with existing law in mind to allow taxpayers flexibility in controlling the timing and character of income from the instruments. Therefore, economically similar investments may have dramatically different, and largely elective, U.S. tax consequences. The principal goals of financial product tax reform could be to provide uniform rules for broad classes of financial products and risk management activity that would simplify the area and provide for consistent tax treatment.

REFORM OPTIONS

I. TAXATION OF DIFFERENT TYPES OF INCOME AND ENTITIES

1. Treat all or most types of income the same, while maintaining the two levels of tax on the earnings of C corporations

a. Tax capital gains, dividends, and ordinary income at the same rates (Testimony of Dr. Leonard Burman before Joint Finance Committee and Ways and Means Committee Hearing, September 20, 2012; Domenici and Rivlin, "Restoring America's Future," Bipartisan Policy Center, November 2010)

i. For example, capital gains and dividends could be taxed as ordinary income, excluding the first $1,000 of realized net capital gains (Domenici and Rivlin, "Restoring America's Future," Bipartisan Policy Center, November 2010)

b. Tax dividends as ordinary income (Altman, et al., "Reforming Our Tax System, Reducing Our Deficit, Center for American Progress," December 2012)

c. Narrow the difference between ordinary income rates and capital gain and dividend rates (Testimony of Dr. Lawrence B. Lindsey before Joint Finance Committee and Ways and Means Committee Hearing, September 20, 2012, coupled with reducing ordinary income tax rates; Altman, et al., "Reforming Our Tax System, Reducing Our Deficit," Center for American Progress, December 2012)

2. Fully integrate the corporate and individual income taxes through one of the following approaches

As discussed above, some people believe that a business's earnings should be taxed at the same rate regardless of whether it is a C corporation or passthrough. This is a goal that some refer to as "integration" of the individual and corporate tax systems. There are a number of different proposals for integration, each with its own set of complexities due to the number of structural issues that need to be addressed. Those issues include how to treat capital gains, foreign corporations, tax-exempt and foreign shareholders, and corporations that reduce the corporate level tax on their earnings through tax preferences.

a. Tax dividends as ordinary income and provide shareholders with a tax credit for corporate taxes paid, sometimes called an "imputation credit" (Warren, "Integration of the Individual and Corporate Income Tax Laws," American Law Institute, 1993)

    i. Treats the corporate tax as a withholding tax on dividends paid to shareholders

    ii. Tax-exempt shareholders such as nonprofits, retirement plans and foreign investors would not benefit from the credit

    iii. Treatment of capital gains would be adjusted to ensure that corporate earnings are taxed once at the individual level

b. Tax dividends as ordinary income and allow corporations to deduct dividends paid to the extent that earnings were taxed at the corporate level, sometimes

called a "dividends paid deduction" (Treasury Department, "Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984)

   i. No deduction would be allowed for dividends paid to tax-exempt shareholders, such as nonprofits, retirement plans and foreign investors
   ii. Treatment of capital gains would be adjusted to ensure that corporate earnings are taxed once at the individual level

c. Allow shareholders to exclude dividends received to the extent the dividend is from previously taxed corporate income (President's Advisory Panel on Federal Tax Reform, 2005; Treasury Department, "Integration of Individual and Corporate Tax Systems," 1992)
   i. Dividends from non-previously taxed income would be taxed at ordinary rates
   ii. Retain current system of taxing foreign shareholders under withholding tax regime
   iii. Shareholders could exclude some capital gains on the sale of stock
d. Disallow interest and dividend deductions for all businesses and allow investors to exclude both interest and dividends, sometimes called a comprehensive business income tax (CBIT) (Treasury Department, "Integration of Individual and Corporate Tax Systems," 1992; Organisation for Economic Cooperation and Development, "Reforming Corporate Income Tax," 2008)
   i. Treats business income paid as interest or dividends the same
   ii. Rules would apply to both passthroughs and C corporations
e. Allow corporations to deduct a percentage of the amount they have raised through equity markets each year, sometimes referred to as an "allowance for corporate equity" (ACE) (Warren, "Integration of the Individual and Corporate Income Tax Laws," American Law Institute, 1993; Organisation for Economic Cooperation and Development, "Reforming Corporate Income Tax," 2008; Kleinbard, "Rehabilitating the Business Income Tax," The Hamilton Project, June 2007; similar to the law in Brazil)
   i. Allows corporations to deduct a fixed return on the capital they raise from shareholders, similar to how they can deduct interest they pay on capital they raise from bondholders
   ii. Either tax investors:
      1. Under current tax principles, or
      2. Impose tax annually on an amount equal to the deduction claimed by the business and exempt all other income at the investor level
   iii. System could apply to all businesses or just C corporations

f. Treat all business entities as passthrough entities so that all business income is directly taxed to the owners, sometimes called "shareholder allocation" (Congressional Budget Office, "Taxing Businesses Through the Individual Income Tax," 2012)
    i. Shareholders include allocated amounts of income, and credit corporate taxes paid and corporate tax credits against their tax liability (McNulty, Commentary; Preserving the Virtues of Subchapter S in an Integrated World, Tax Law Review, 1992)

3. Partially integrate the corporate and individual income taxes

Currently, the U.S. partially integrates the corporate and individual income taxes by applying a lower rate of tax to certain dividends and long-term capital gains on the sale of C corporation stock.

a. Tax dividends as ordinary income and allow a partial imputation credit or dividends paid deduction, as described above
b. Adjust the rates under the corporate and individual income taxes so that the combined rate on corporate income and dividends received is closer to the rate on passthrough business income
    i. For example, the difference in the top individual and corporate tax rates could be increased (President's Economic Recovery Advisory Board, 2010)
    ii. Alternatively, taxes on dividends and capital gains on C corporation stock could be lowered or repealed (H.R.4529 (111th Congress), Roadmap for America's Future Act of 2010, sponsored by Rep. Ryan; Gingrich, American Enterprise Institute, "Capital Gains: An Argument for Repeal," August 2009; Institute on Taxation and Economic Policy, "A Capital Idea," January 2011)
c. Tax capital gains at ordinary income rates except those from the sale of C corporation stock (President's Advisory Panel on Federal Tax Reform, 2005)

4. Redraw line between passthroughs and C corporations

a. Require more or all publicly-traded partnerships to pay tax as C corporations (S.1624 (110th Congress), A bill to … provide that the exception from the treatment of publicly traded partnerships as corporations for partnerships with passive-type income shall not apply to partnerships directly …, sponsored by Sens. Baucus, Grassley, Brown, and others; Lee, "Entity Classification and

Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process," Virginia Tax Review, 1988)

b. Require larger passthrough businesses to pay tax as C corporations
    i. Although there is currently no uniform definition of larger businesses, size could be defined based on gross revenues, number of owners, or access to capital markets or the equivalent (President's Framework for Business Tax Reform, 2012; President's Economic Recovery Advisory Board, 2010)
    ii. Alternatively, allow businesses to be taxed as a passthrough if the owners materially participate in the business or the business is closely-held (Lee, "Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process," Virginia Tax Review, 1988; Yin, "Publicly Traded Partnerships, Closely Held Corporations, and Entity Classification for Tax Purposes," Virginia Law and Economics Research Paper, January 2010)
c. Modify the rules on how partnerships are taxed; for example:
    i. Extend partnership basis limitation rules to nondeductible expenditures (FY2014 Administration Budget Proposal; estimated in 2013 to raise $1 billion over 10 years)
    ii. Expand the definition of built-in loss for purposes of partnership loss transfers (FY2014 Administration Budget Proposal; estimated in 2013 to raise $1 billion over 10 years)
    iii. Enact other specific rules, including requiring basis adjustments when interests are transferred or property is distributed, and repealing the 7-year limitation so that a contributing partner recognizes gain when appreciated property is distributed to another partner (Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013)
d. Allow or require more businesses to pay tax on a passthrough basis
    i. If the top corporate rate is significantly reduced, discourage businesses from electing C corporation taxation
        1. Only allow publicly-traded companies to pay tax as C corporations (Burke, "Passthrough Entities: The Missing Element in Business Tax Reform," Pepperdine Law Review, 2013; Yin, "Corporate Tax Reform, Finally, After 100 Years," Virginia Law and Economics Research Paper, September 2009)
        2. Eliminate the low rate brackets for C corporations (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue

Options," March 2011, estimated in 2011 to raise $24 billion over 10 years; Ways and Means Committee Discussion Draft on International Tax Reform, 2011)

   ii. Ease the rules on S corporations, so that more entities can benefit from passthrough taxation
      1. Loosen the requirements for electing to pay tax as an S corporation, for example, by reducing the holding period for built-in gains, repealing excessive passive income as a termination event, and expanding who may be an eligible shareholder (Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; H.R.892, (113th Congress), S Corporation Modernization Act of 2013, sponsored by Reps. Reichert, Kind, and others)

e. Revise rules regarding RICs and REITs
   i. Reduce amount and type of activity that can be conducted in a REIT or RIC subsidiary (Taylor, "'Blockers,' 'Stoppers,' and the Entity Classification Rules," Tax Lawyer, July 2011)
   ii. Expand REITs by expanding amount of property REIT may sell (H.R.5746 (112th Congress), Update and Streamline REIT Act of 2012, sponsored by Reps. Tiberi and others)
   iii. Repeal the preferential dividend rule for publicly-offered REITs (FY2014 Administration Budget Proposal; estimated in 2013 to raise less than $1 billion over 10 years)

5. Simplify other rules related to types of income and entities

a. Conform rules for S corporations and partnerships (Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; President's Advisory Panel on Federal Tax Reform, 2005)
b. Harmonize the different rates on capital gains (President's Economic Recovery Advisory Board, 2010)
   i. For example, apply the same rates to collectibles, section 1202 qualified small business stock, section 1256 contracts, and section 1250 property
c. Equalize the tax treatment between corporate and non-corporate entities for the exclusion from income of government incentives and other contributions to taxpayers (Blanchard, "The Taxability of Capital Subsidies and Other Targeted Incentives," Tax Notes, November 1999; Letter from Reps. Conway and others to

Ways and Means Committee Chairman Camp and Ranking Member Levin regarding Clean Coal Power Initiatives, October 12, 2012)

II. CORPORATE FINANCE DECISIONS

1. Expand thin capitalization rules to limit deductions attributable to excessive debt financing

a. Disallow interest expense deductions for a U.S. corporation or a foreign corporation engaged in a U.S. trade or business to the extent the interest expense exceeds, for example, 25% of adjusted taxable income, as described in the International Competitiveness options paper (similar to the laws of Germany and Italy)

2. Further limit deductions associated with exempt or deferred income

a. Offshore earnings
   i. Defer interest deduction associated with unrepatriated foreign earnings (FY2014 Administration Budget Proposal; estimated in 2013 to raise $60 billion over 10 years)
   ii. Deny interest deduction on debt incurred to acquire tax-exempt foreign operations (Fleming, Peroni, and Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty," Florida Tax Review, 2012; similar to proposals and laws in France, Spain, and the Netherlands)

b. Limit interest deductions to the extent attributable to loans used for capital expenditures eligible for expensing (Geier, "Expensing and the Interest Deduction," Tax Notes, September 2007)

3. Create greater parity between debt and equity financing for C corporations

a. Reduce the amount of interest payments that C corporations can deduct by, for example, 10% (President's Economic Recovery Advisory Board, 2010; Pozen, "Reform Tax Code by Limiting Corporate Interest Deduction," Newsday, October 2012; Viard, "The Quickest Way to Wreck Corporate Tax Reform," American Enterprise Institute, March 2013; Brill, "A Pro-Growth, Progressive, and Practical

Proposal to Cut Business Tax Rates," American Enterprise Institute, January 2012)

i. Could provide a floor allowing full deductibility for interest payments up to, for example, $5 million
ii. Could apply to gross or net interest payments
iii. Could treat business rental expense as interest for purposes of the rule

b. Disallow interest deductions for interest paid on debt used to redeem corporate equity (Joint Committee on Taxation, "Federal Income Tax Aspects of Corporate Financial Structures," January 1989)
c. Fully integrate the corporate and individual income taxes, as described above, so that debt and equity are taxed the same

4. Create greater parity between retaining and distributing earnings for C corporations and reduce lock-in incentives

a. Apply a lower rate to dividends than applies to capital gains on C corporation stock (Gravelle, "The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues," Congressional Research Service, April 2008)
b. Expand mark-to-market by, for example, requiring private companies with more than $50 million in net assets and individuals representing the wealthiest 0.1 percent of Americans to mark-to-market publicly-traded property and derivatives (Miller, "A Progressive System of Mark-to-Market Taxation," Tax Notes, October 2010)
c. Repeal the one-year holding period requirement for preferential capital gains rates (Paschall, "U.S. Capital Gains Taxes: Arbitrary Holding Periods, Debatable Tax Rates," Southern California Law Review, 2000)
d. Strengthen the accumulated earnings tax applicable to excess retained earnings of a C corporation (Elliott, "The Accumulated Earnings Tax and the Reasonable Needs of the Business: A Proposal," William and Mary Law Review, 1970)

e. Repeal the rule that exempts capital gains from tax when asset is transferred upon death (sometimes referred to as "stepped-up basis") (Testimony of Dr. Leonard Burman before Joint Finance Committee and Ways and Means Committee Hearing, September 20, 2012; McCaffery, "A Progressive's Silver Linings Playbook: Repeal Stepped-Up Basis," Tax Notes, February 2013)

i. Replace with a rule where the recipient pays tax on capital gain upon receipt or when the recipient sells the asset (sometimes referred to as "realization" and "carryover basis")

III. COMPENSATION

1. **Reform treatment of carried interest and other partnership interests received in whole or in part in exchange for services**

    a. Tax all interests in partnerships that are received solely in exchange for services as compensation rather than capital gains (FY2011 Administration Budget Proposal; estimated in 2010 to raise $29 billion over 10 years; Testimony of Mark Gergen before the Finance Committee, July 11, 2007)

    b. Tax carried interest earned by investment managers in exchange for providing services to an investment partnership as compensation rather than capital gains (FY2014 Administration Budget Proposal; estimated in 2013 to raise $17 billion over 10 years; S.268 (113th Congress) CUT Loopholes Act of 2013, sponsored by Sens. Levin and Whitehouse; Amendment to H.R.4213 (111th Congress), American Jobs and Closing Tax Loopholes Act of 2010, sponsored by Sen. Baucus; Congressional Budget Office, "Reducing the Deficit: Revenue and Spending Options," 2011)

    c. Disallow conversion of management fees taxed as ordinary income into partnership shares taxed at capital gains rates (Polsky, "Private Equity Management Fee Conversions," Tax Notes, February 2009)

2. **Reform treatment of S corporation income received in whole or in part in exchange for services**

    a. Apply self-employment taxes to income of passthroughs engaged in personal service businesses (S.3793 (111th Congress), Job Creation and Tax Cuts Act of 2010, sponsored by Sen. Baucus; FY2013 Administration Budget Proposal; estimated in 2012 to raise $8 billion over 10 years)

        i. Limit taxable amounts to passthrough business owners who provide substantial professional services to the business

            1. Professional services defined to include any trade or business providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or brokerage

        ii. Impose payroll taxes only on S corporations that derive 75% or more of their gross revenues from services of 3 or fewer shareholders or when the S corporation is a partner in a professional service business

        iii. Could also limit to taxpayers with income greater than $200,000 for individuals and $250,000 for married couples filing jointly

b. Treat wages as well as any ordinary income flowing through to S corporation shareholders as subject to self-employment taxes when the shareholder owns at least 10% of the stock or materially participates in the business (Hennig et al., "S Corp Taxation: Level the Playing Field," Tax Notes, March 2013)
c. Treat S corporation earnings either as wages subject to the 3.8% Medicare tax or as net investment income subject to the 3.8% net investment tax, at the shareholder's election (Hennig et al., "S Corp Taxation: Level the Playing Field," Tax Notes, March 2013)
    i. Expand the definition of net investment income to include S corporation flow-through income for purposes of the 3.8% net investment tax
    ii. Modify the definition of wages to include any distributions by the corporation within 2.5 months after the close of the tax year

IV. FINANCIAL PRODUCTS

Financial products are transactions allowing a person to make an investment or to manage a financial risk. Financial products include stock and bonds. They also include derivatives, which are contracts the value of which is determined by reference to a specified asset, such as a stock, bond, commodity, or currency. There are three central issues associated with the taxation of financial products. The first relates to timing, meaning when a taxpayer is required to (or is allowed to) take income or expense from the financial product into account in determining tax liability. The second relates to character. Dividends and capital gains may be eligible for reduced rates as compared with ordinary income. Losses from capital assets ("capital losses") first offset a taxpayer's capital gains to the extent thereof and then $3,000 of ordinary income. Capital gains and ordinary income are taxed at the same rate for corporations. Corporations can only offset capital losses against capital gains. The third issue is the source of income. Foreign investors in financial products may be subject to U.S. tax on payments on a financial product if those payments are considered to be from United States sources. This options paper focuses on the timing and character issues.

Tax rules for derivatives

The following is a description of certain common derivatives and their tax treatment. Many derivatives are combinations, or hybrids, of the derivatives described below.

- **Options.** An option is a contract that gives the holder the right, but not the obligation, to buy or sell property at a designated price within a set period or at a specified date. A right to buy is generally called a "call" option, while a right to sell is generally called a "put" option. Typically, the option holder pays the option issuer a fee (called a "premium") upon entering into the contract. Under current law, an option holder generally recognizes gain or loss on the contract only when the holder sells the option or when it expires unexercised. The character of any such gain or loss is determined by reference to what the character of the gain or loss would be if the holder owned the underlying property. If the option is exercised, the premium is considered part of the holder's purchase price for the property. Similarly, tax consequences to the option issuer from receiving the premium only arise when the option is exercised or expires. If the option is exercised, the issuer sells the property to the option holder, and the issuer's income is treated as capital gain. If the option expires, the issuer is taxed on the premium as a short-term capital gain even though no sale takes place.

- **Forward and futures contracts**. A forward contract is an agreement by a buyer to purchase specified property from the seller at a fixed price on a specified date in the future. A "futures contract" is a standardized forward contract that is traded on an exchange and is subject to a variety of special terms to minimize the risk that a party would default on the contract. Futures contracts are subject to special rules regarding timing and character (discussed in the options below).

  Forward contracts can be physically settled, whereby the buyer acquires the specified property, or cash settled, whereby the specified property is not exchanged but a payment is made from the buyer or seller to the other to reflect the difference between the price specified in the contract and the price of the underlying property on the settlement date. Similar to an option, under current law, the buyer and seller do not recognize income on the contract until settlement. If a contract physically settles, the specified property is transferred, and the seller has gain or loss from the transaction. If the contract cash settles, the party receiving the cash determines the character of the income by reference to what the character of the income would be if the party owned the underlying property.

- **Swaps and other notional principal contracts**. Notional principal contracts are contracts that provide for periodic payments by one party to another calculated by reference to a specified index and a notional amount of property that the parties to the contract may not own. A "swap" is a common form of notional principal contract. The timing of income under a notional principal contract depends on whether a payment is

made pursuant to the terms of the agreement or is made to end the agreement or assign the obligations under the agreement ("termination payments"). Payments pursuant to the agreement, whether periodic or nonperiodic, are included in a taxpayer's income or are deductible on an accrual basis. For example, for payments expected to be received, a taxpayer must take a ratable portion of an expected payment into income each day and include such amount in taxable income. Large nonperiodic payments may, in certain circumstances, be treated as a loan that is separate from the notional principal contracts and subject to the rules for debt instruments. Termination payments are taken into account as income or as a deduction when paid. Proposed Treasury regulations, which are not binding on taxpayers, provide that payments made pursuant to the terms of the agreement are ordinary, while termination payments are capital.

1. **Harmonize the tax rules governing most or all derivatives**

    a. Harmonize the timing rules governing when taxpayers must recognize income on derivatives through one of the following reforms (Testimony of Alex Raskolnikov before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)
        i. Require taxpayers holding derivatives to mark-to-market the derivative each year, meaning that the derivative is treated as sold at the end of each year and gains or losses from the deemed sale are taken into income (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013; FY2014 Administration Budget Proposal; estimated in 2013 to raise $16 billion over 10 years)
        ii. Require taxpayers holding derivatives to recognize income ratably each year based on the expected payouts on the derivative
        iii. Require taxpayers holding derivatives to pay an interest charge on gains from derivatives to undo any timing benefits

    b. Harmonize the rules governing the character of income from derivatives
        i. Treat all income from derivatives as ordinary income (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013; FY2014 Administration Budget Proposal; estimated in 2013 to raise $16 billion over 10 years)
        ii. Treat all income from derivatives as capital or ordinary based on the underlying investment (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)

c. Apply harmonized rules to all derivatives (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013)
   i. Alternatively, could only apply harmonized rules to:
      1. Derivatives that are actively traded or based on property that is actively traded (FY2014 Administration Budget Proposal; estimated in 2013 to raise $16 billion over 10 years)
      2. Exchange-traded derivatives (Testimony of Alex Raskolnikov before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)
      3. Derivatives entered into with dealers (Testimony of Steve Rosenthal before the Ways and Means Committee, March 20, 2013)
         I. Dealers would be required to report valuations to their counterparties
         II. Derivatives that are marked to market for financial accounting purposes
   ii. Exempt ordinary course transactions from harmonized rules (for example, transactions in American Depository Receipts or one corporation's acquisition of another corporation that is undertaken through a stock purchase agreement that otherwise qualifies as a forward contract) (Miller, "Toward an Economic Model for the Taxation of Derivatives and Other Financial Instruments," Harvard Business Review, 2013; Testimony of William Paul before the Ways and Means Committee, March 20, 2013)
      1. Could also define ordinary course transactions to be those eligible for the financial accounting exception to mark-to-market treatment

2. Reform mark-to-market treatment (section 475)

Dealers and market makers in securities are required to "mark-to-market" annually their financial assets other than those that are held for investment. Any gain or loss recognized is treated as ordinary unless the financial instrument is not held as part of the taxpayer's dealer operations. Dealers in commodities and traders in securities or commodities can elect mark-to-market and ordinary treatment.

a. Expand ability of taxpayers to elect mark-to-market and ordinary income treatment

i. Allow all taxpayers to elect mark-to-market and ordinary income treatment (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)

3. **Reform rules governing certain futures and other contracts (section 1256)** (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)

Futures contracts generally must be "marked-to-market" annually. Gains and losses on futures contracts are treated as 60% long-term capital gain or loss, and 40% short-term capital gain or loss. Certain foreign currency contracts and non-equity options are also subject to this treatment. In addition, with respect to dealers or market makers, this tax regime also applies to dealer equity options and dealer securities futures contracts. Rules also coordinate this mark-to-market regime with the mark-to-market rules applicable to dealers and market makers.

a. Put dealers and market makers under one set of mark-to-market and ordinary income rules
b. Repeal the 60% long-term capital gain or loss and 40% short-term capital gain or loss characterization, making income on these contracts ordinary income for all taxpayers
c. Expand the scope of mark-to-market treatment, for example, by extending rules to other exchange-traded instruments

4. **Simplify and expand hedging treatment**

Taxpayers that use a financial instrument to hedge the risk of holding ordinary property or liabilities are subject to special tax rules. Typical risks that are hedged are the risk of interest rate or price changes, and risks regarding foreign currency fluctuations. When a taxpayer uses a financial instrument (typically a derivative) to hedge another risk, a taxpayer can choose (or the tax law may require) the integration of the derivative and the item being hedged. This means that the derivative and the underlying item are treated as one investment in order to match the timing and character of the income from the derivative and the income from the underlying item. Under current law, hedging treatment (that is, the matching of timing and character between the derivative and the underlying property) is allowed for limited classes of property that give rise to ordinary income, loss, or deduction. In addition, the tax rules generally require that the hedging relationship be identified by the taxpayer at the outset of the hedge.

a. Allow book hedging (that is hedging for financial accounting purposes) to qualify as identification (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013; Testimony of Steve Rosenthal before the Ways and Means Committee, March 20, 2013)
b. Allow capital asset hedging (Testimony of Andrea Kramer before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)
c. Allow affiliated group risk consolidation and hedging, including for both domestic and foreign affiliated groups (Testimony of Andrea Kramer before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)

5. Reform treatment of debt

The primary income from debt instruments is interest and original issue discount. Original issue discount generally arises when there is a difference between the issue price of the debt and the amount that will be paid at maturity. For example, if a corporation issues a 5-year bond for $80 with a single payment of $100 due at maturity, the original issue discount is $20. Generally, interest income is taxed annually based on the actual amount paid. Original issue discount is taxed on an accrual basis. In the above example, the $20 of original issue discount would be taken into income over the five years the instrument is outstanding. Interest and original issue discount are ordinary income. Gains and losses on the sale of debt are generally capital. Under current law, if an issuer modifies existing debt or exchanges existing debt for new debt, the transaction is generally taxable to the debt holder unless certain narrow exceptions apply for corporate issued debt that qualifies as a security for tax purposes.

When debt is purchased after issuance at a discount to its face amount (that is, the amount that will be paid at maturity), the difference between the debt instrument's purchase price and the face amount is referred to as "market discount." Market discount can arise if market interest rates rise after a fixed rate debt instrument is issued. Alternatively, market discount can arise if the creditworthiness of the issuer declines. Current rules treat gain on the sale or exchange of a debt instrument, or upon a principal payment of the debt instrument, as ordinary income rather than as capital gain to the extent of accrued market discount at the time of the sale or payment. A taxpayer can elect to accrue the market discount into income (i) by applying the principles of the original issue discount rules or (ii) on a straight line basis if the debt instrument only provides for regular interest payments prior to maturity. Nevertheless, some commentators have argued that even with these elections, the market discount rules lead to inappropriate timing and measurement of income to the extent market

discount is from a decline in the creditworthiness of the issuer rather than from a change in market interest rates.

a. Because most income from debt is ordinary income, treat losses on debt as ordinary losses, potentially just to the extent of interest income recognized on the debt (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)
b. Expand the scope of tax-free debt-for-debt exchanges to include exchanges involving noncorporate debt issuers and non-securitized debt (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011; Testimony of David Garlock before the Ways and Means Committee, March 20, 2013)
c. Reform treatment of distressed debt
    i. Reduce situations in which cancellation of indebtedness income is recognized on debt modifications if the principal amount of the debt has not changed (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011; Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013)
    ii. Revise market discount rules to better distinguish market discount arising from changes in interest rates from market discount attributable to credit risk (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013)
        1. Make accrual of market discount mandatory,
        2. Limit rate of accrual to a time value return (therefore reducing the effect of creditworthiness on the amount of income subject to the market discount rules), or
        3. Eliminate accrual for severely distressed debt

6. Reform "wash sales" rules (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011; Testimony of Steve Rosenthal before the Ways and Means Committee, March 20, 2013)

The "wash sale" rules prevent a taxpayer from selling an asset to recognize a built-in loss and then repurchasing the same or a substantially identical asset. Essentially, this rule allows a taxpayer to recognize a loss only when a taxpayer has truly disposed of an asset. The wash sale rules defer the recognition of a loss on the sale of stock or securities if a taxpayer acquires, or enters into an option to acquire, shares of

substantially identical stock or securities within 30 days before or after the loss transaction. The wash sale rules also apply to short sales of stock or securities (borrowing and selling stock or securities) and securities futures contracts to sell stock or securities.

a. Expand rules to cover either exchange-traded derivatives or all derivatives
b. Provide that taxpayers can enter into wash sales effected through taxable, tax-exempt, or tax-deferred accounts, and through sales by related persons
c. Apply wash sale rules to other short positions in financial instruments, such as "put" options and entering into a forward contract to sell stock or securities
d. Expand the "substantially identical" standard to apply to more replacement securities, for example, by treating indexed mutual funds and exchange-traded funds as substantially identical in appropriate circumstances

V. OTHER

1. Streamline partnership audits

a. Streamline audit and adjustment procedures for larger partnerships (FY2014 Administration Budget Proposal; estimated in 2013 to raise $2 billion over 10 years)

2. Mergers and acquisitions

Under current law, a complex set of rules for "tax-free reorganizations" allows taxpayers to defer taxation of gain or loss on certain exchanges of stock for the stock of another corporation or certain transfers of assets in exchange for stock or securities of another corporation. These rules are intended to apply in the case of an exchange which is incident to a restructuring of one or more corporations and where the assets remain held by a corporation, the shareholders of both combining businesses remain shareholders in the surviving corporation, and there is a valid business purpose for the transaction. According to CNN Money, there was almost $1 trillion of U.S.-based mergers and acquisition activity in 2012.

a. Modernize and simplify the tax-free reorganization provisions (Senate Finance Committee, "The Subchapter C Revision Act of 1985: A Final Report," 1985)
    i. Allow C corporations to elect whether to treat a reorganization transaction as tax-free or taxable

   ii. Allow C corporation shareholders to elect whether to treat a reorganization transaction as tax-free or taxable

b. Amend the related party redemption rules for corporate shareholders to deny dividend treatment on certain sales of stock (section 304) (Bittker and Eustice, "Federal Income Taxation of Corporations and Shareholders," 2000)
c. Amend the reorganization rules relating to spin-offs and similar distributions so that the distributing corporation has taxable gain upon the receipt of securities or nonqualified preferred stock (i.e., preferred stock with debt-like attributes) of certain newly formed controlled companies (S.1813 (112th Congress), Moving Ahead for Progress in the 21st Century Act, sponsored by Sens. Boxer, Baucus, and others; amendment to H.R.4213 (111th Congress), American Jobs and Closing Tax Loopholes Act of 2010, sponsored by Sen. Baucus)
d. Repeal the dividend within gain limitation in reorganizations (FY2014 Administration Budget Proposal; estimated in 2013 to raise $1 billion over 10 years; Amendment to H.R.4213 (111th Congress), American Jobs and Closing Tax Loopholes Act of 2010, sponsored by Sen. Baucus)

3. Other tax administration or tax gap issues

a. Permit S corporation elections to be made on the business's first federal tax return (S.2271 (112th Congress), Small Business Election Simplification Act, sponsored by Sens. Franken, Enzi, and Snowe; Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; American Bar Association, "Options for Tax Reform in Subchapter S of the Internal Revenue Code," April 2013; National Taxpayer Advocate, "2012 Annual Report to Congress," January 2012)
b. Alter deadlines of S corporation and partnership returns (S.420 (113th Congress), Tax Reform Due Date Simplification and Modernization Act of 2013, sponsored by Sens. Enzi, Stabenow, and others; Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; Testimony of Troy Lewis before the Finance Committee, April 26, 2012)
c. Require S corporations to calculate shareholder basis in the corporation's stock and report the information on Schedule K-1s (Government Accountability Office, "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules," December 2009)