SIMPLIFYING AMERICA'S TAX SYSTEM

Globally Competitive - Economic Growth - Fiscally Responsible

Simplifying America's Tax System plan is a comprehensive tax reform option which lowers rates for all individuals and eliminates corporate-level taxation in favor of a single-digit consumption-style tax. We need a new and intellectually honest tax platform that will trigger economic growth and job creation without picking winners and losers.

Congressman James B. Renacci

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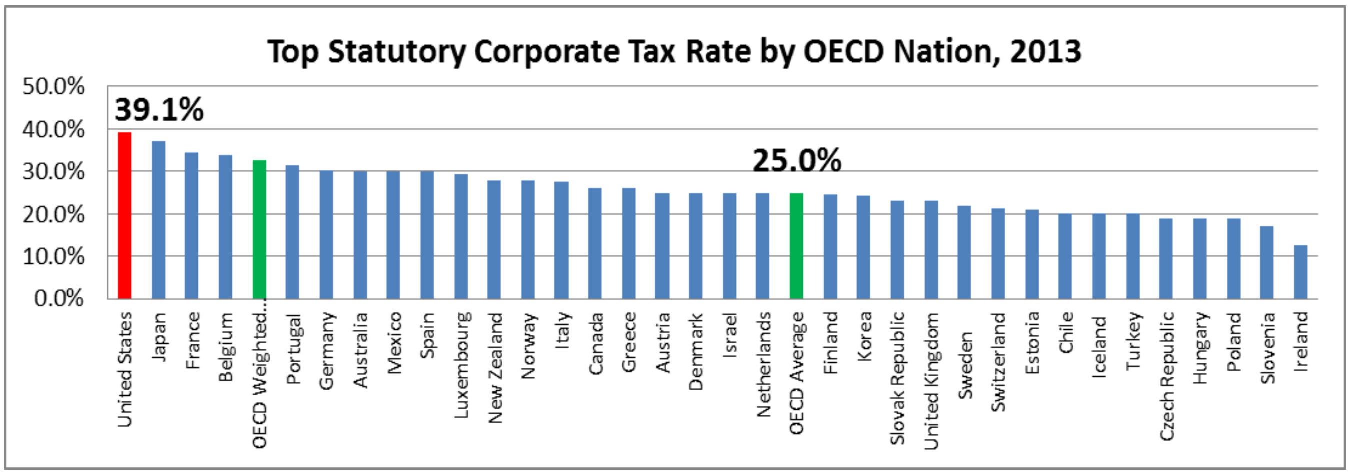
http://renacci.house.gov/simplifying-americas-tax-system

Overview

America is the global leader in technology, energy, finance, and innovation. Yet, our obsolete tax code—one that has not been reformed in 30 years—inhibits our true economic potential and constrains opportunities for all Americans.

By failing to overhaul our tax system, the U.S. has fallen drastically behind. Over the last three decades, the average corporate income tax rate among the now 35 countries in the Organisation for Economic Co-operation and Development (OECD) has fallen from 48% to under 25%. Since 2000, we are one of only three OECD countries that have NOT cut their corporate tax rate. Now with the highest corporate tax rate in the industrialized world, it's no wonder U.S.-based businesses hold back on domestic investment and hiring plans. We need a tax platform that fosters growth, encourages investment, and ensures a level playing field.



Who bears the burden of our high corporate tax rate? It does NOT fall on corporations; it falls on PEOPLE. In other words, "companies don't just pay corporate taxes out of their own pockets. They pass it along in the form of lower wages and benefits to the work force, higher prices for consumers and lower stock valuations for investors. One key reason why average wage earners have had virtually no pay increases in the past 15 years is the high corporate tax rate. That is why so many Americans are so angry at Washington – They want BIG change."[i]

We can't settle for middle of the pack. The Simplifying America's Tax System (SATS) plan delivers that big change.

On the business side, this pro-growth plan will repeal the corporate income tax and replace it with a single-digit tax on business activities,[ii] subjecting all business income to one level of income taxation. This credit-invoice based consumption tax is not an untested economic experiment; rather, every other OECD country institutes a similar charge on goods and services. But importantly, no other OECD country has eliminated its corporate income tax; thus, with only a single-digit consumption tax, SATS will make the U.S. the most competitive tax system in the world. And, since all businesses will have the option to be treated as a corporation for tax purposes, SATS ensures a level playing field by not picking winners and losers.

On the individual side, SATS will reduce income tax rates for all taxpayers. It will also simplify the tax code by significantly increasing the standard deduction; a family of four will have no income tax liability on income up to $50,000. SATS will also eliminate the marriage penalty and expand the Earned Income Tax Credit. Even accounting for the impact of the consumption tax, low-to-middle income households will see an after-tax increase in income similar to higher income households.

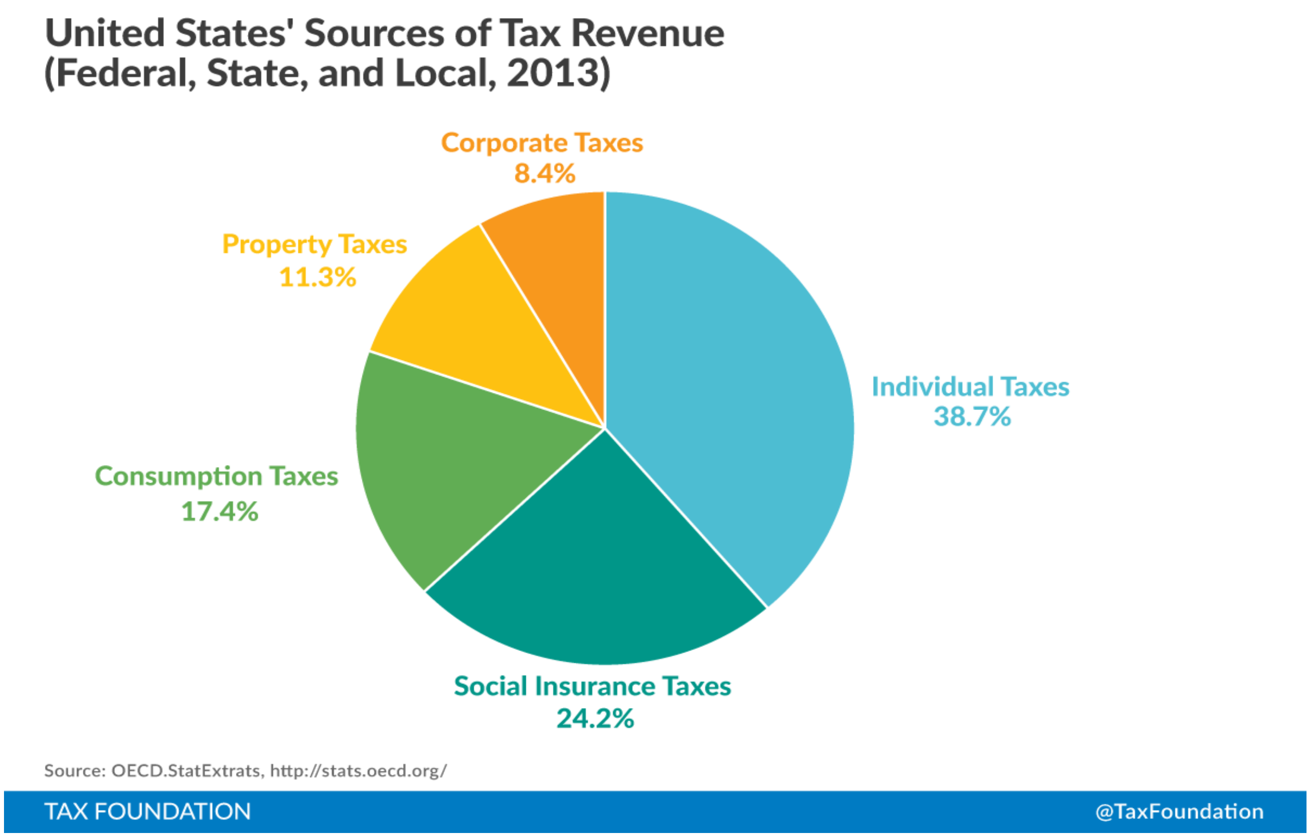
These are big, bold ideas. While some may say that such a plan is too far outside the mainstream to be politically viable, "we are at the point where we need an overhaul, not an oil change."[iii] SATS delivers that much-needed overhaul.

I recognize this overhaul won't happen overnight. Rather, I view this as the beginning of the conversation and seek your feedback. Please submit comments and questions to TaxReform.Renacci@mail.house.gov. I look forward to your ideas to transform America's tax code so that it will provide opportunity for all Americans. Your success should be up to you, not the tax code.

Business Taxation

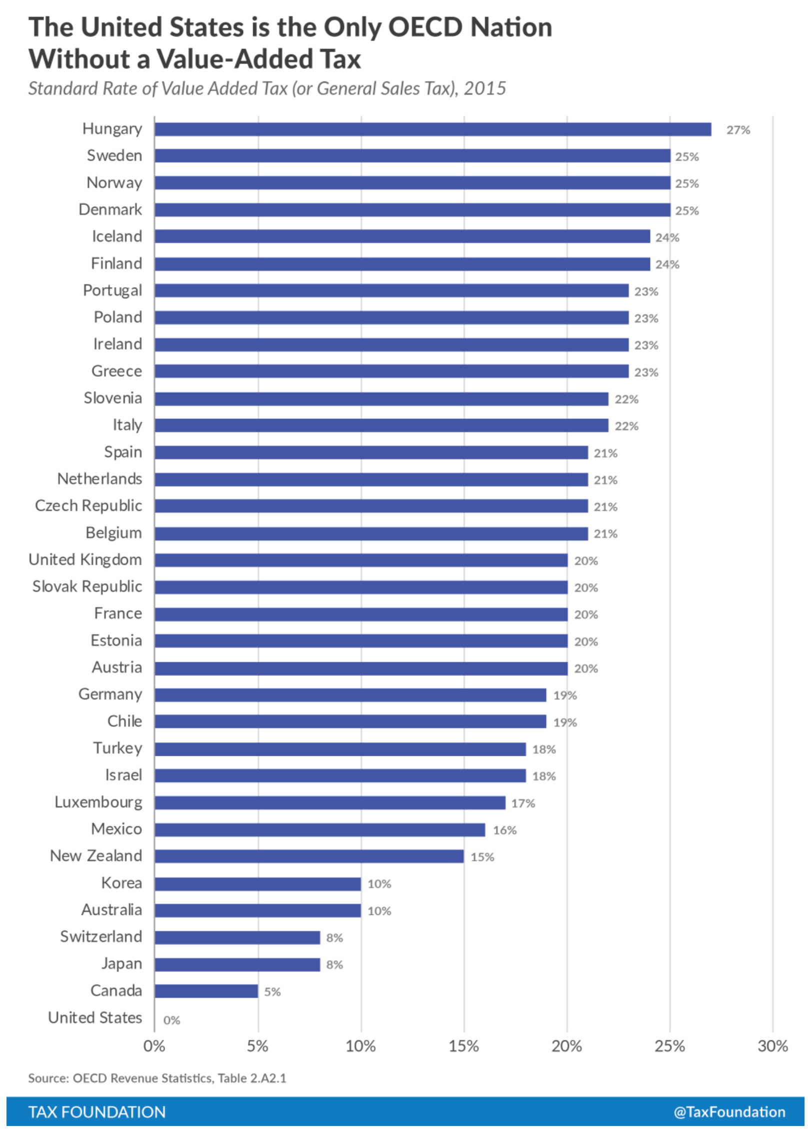
It's widely accepted who bears the burden of the corporate tax: it does NOT fall on some faceless corporate entity; rather, it's borne by PEOPLE—customers, workers, and investors. While "there is some debate about which group of people bears more or less of the tax … the main point, and one about which there is no debate, is that individuals bear the corporate income tax."[iv] This is not a partisan issue; progressives have championed eliminating the corporate income tax because, among other reasons:

- "You can't tax a corporation; you can only tax a person."
- "The incidence of 'corporate' taxes is not necessarily progressive."
- "The corporate income tax encourages firms to use debt finance, rather than equity."
- "The corporate income tax encourages firms to waste resources on tax avoidance."
- "If we get rid of the corporate income tax, we could eliminate the special treatment for dividends and capital gains."
- "The corporate income tax doesn't raise that much money."[v] (Less than 9% of 2013 revenue.)



SATS removes these distortions. It zeroes out the corporate income tax to make our tax code the most competitive in the world.[vi] Importantly, pass-through entities are not left behind; SATS allows them to elect to be treated as a corporation for the zero percent rate. Thus, no matter how a business is organized, SATS subjects all business income to only one level of income taxation, embracing corporate integration. Indeed, ensuring business income is just taxed once—regardless of legal form—is one of the true hallmarks of "ideal" business tax reform.[vii]

Repealing the corporate income tax is unquestionably pro-growth. But, at the same time, fiscal responsibility cannot be thrown out the window; thus the question is how to replace that lost revenue? SATS does so by instituting a 7% tax on business activities—similar to consumption tax measures used in every other OECD country.[viii]



This business activity tax will impose a tax on goods and services in a manner similar to the consumption tax plan introduced by Senator Cardin.[ix] In other OECD countries, this is typically known as the credit-invoice value-added tax (or goods-and-services tax), a measure that raises revenue with significantly less economic damage than the corporate income tax.[x] Under the credit-invoice method, businesses collect tax on all of their sales, but that tax is *reduced* in the form of a credit for tax paid on purchases (i.e. inputs) invoiced from other firms.[xi] Thus, the consumption of goods and services will be taxed only once, at the consumer level.[xii] The invoice requirement achieves two ends: it limits the credits provided for tax paid with respect to inputs purchased by entities subject to the tax (i.e. registered entities), and it ensures that the credit obtained by the purchaser is equal to the tax paid on the input.[xiii] Since a vendor must have opted into the system to get credit for a business's inputs, this invoice mechanism is effectively self-policing.[xiv] The transparent, self-policing nature of the business activity tax, in conjunction with eliminating the corporate income tax – which currently accounts for only a small slice of overall federal revenue – will dramatically reduce the need for IRS personnel.

A zero percent corporate rate will bring a flood of investment to the U.S from foreign firms, as well as from American-based companies who have held accumulated foreign earnings overseas. As a transition to this new system, SATS will implement a one-time tax on accumulated foreign earnings held abroad, 8.75% for profits held as cash and cash-equivalents and 3.5% on other assets. Revenue generated from this repatriation will be dedicated to the Highway Trust Fund. Going forward, switching to a territorial form of corporate income taxation will be unnecessary because of the 0% corporate income tax.

In sum, our nation can't settle for middle of the pack. A simple corporate rate reduction near the OECD average won't stop companies from relocating overseas or being acquired by foreign companies located in jurisdictions with more pro-growth tax regimes. That said, it's disingenuous to compare our corporate income tax rate to other OECD countries without also mentioning the fact that we're the only OECD country without a national-level goods and services tax. While there's no good way to tax, SATS is a bold pro-growth solution to business tax reform that will make our tax system the most competitive in the world.

Individual Taxation

SATS recognizes that business tax reform can't exist in a vacuum. To that end, SATS reduces individual rates across the board and simplifies the individual tax system for all filers.

SATS does this in a way that does not significantly alter the progressivity of the current code. Indeed, even accounting for the impact of the business activity tax, all income quintiles will see a similar after-tax increase in income. SATS accomplishes this by considerably increasing income tax exemptions, providing a $15,000 standard deduction per filer and a $5,000 personal exemption. Thus, a family of four will have no income tax liability on their first $50,000 of income. Moreover, while eliminating most personal credits, SATS retains the Child Tax Credit in its current form, and substantially increases the Earned Income Tax Credit: 100% for childless workers and 40% for all others.

For those who still have a tax liability, SATS slashes rates, consolidating seven marginal brackets into three: 10%, 25%, and 35%. For single filers, the 10% bracket is expanded more than five-fold, up to $50,000 for single filers and $100,000 for joint filers. The 25% bracket extends to $750,000 and $1,500,000 for single and joint filers, respectively. Thus, SATS creates a lower two tier individual tax rate for over 99.9% of taxpayers, while maintaining the current tax treatment for health insurance, education, and retirement savings.

SATS also dramatically simplifies tax filings. First, since a substantial majority of households will take advantage of the generous standard deduction, SATS eliminates all itemized deductions except two, charitable contributions and mortgage interest up to $500,000 of debt. Further, SATS repeals the alternative minimum tax. Thus, individuals will no longer have to compute their income under two different tax systems. Moreover, by repealing the corporate income tax, it obviates the need to treat capital gains and dividends differently from ordinary income.[xv] Taxing all characters of income at the same rate ensures greater fairness and removes current law incentive to aggressively recharacterize ordinary income as capital.

Conclusion

The tax code has not been reformed in almost 30 years. Since President Reagan signed The Tax Reform Act of 1986, our tax code has fallen behind the rest of the world. Congress has an opportunity to work with the next Administration to make serious reforms to our tax code that must not be wasted. Given global trends, a modest corporate rate cut will not suffice in the long run. SATS creates a tax system which: 1) makes the United States the most competitive country in the world, 2) increases after-tax earnings for individuals in all income brackets, 3) increases revenue on a dynamic basis, and 4) simplifies the collection of revenue. SATS combines the benefits of a pro-growth business tax system with corporate integration, while lowering individual rates for all Americans and enhancing work incentives to help lift workers out of poverty. Tax reform must provide a lasting solution for the future. And SATS delivers.

Feedback

Congressman Renacci and his office desire that this plan be the beginning of a conversation on a bold, pro-growth comprehensive tax reform model. Therefore, we request feedback from taxpayers. General comments are welcome, but we are particularly interested in feedback on the issues and questions listed below. While we welcome comments that identify problems, we are especially grateful for ones that also propose solutions.

1. Financial Services: Properly applying a goods-and services tax to financial services—as opposed to financial flows—is one of the most difficult challenges in defining a consumption tax base. While historically many countries have exempted such services from the base, more modern goods-and-services tax regimes which contain a broader base, such as Australia and New Zealand, provide limited financial services exemptions. The business activity tax under this proposal contemplates more closely following the latter model. While the general goal is to keep the consumption tax base broad, we are mindful that any such system needs to be administratively feasible. Thus, we seek feedback from financial services stakeholders—especially those operating in jurisdictions with limited financial services exemptions—detailing their experiences and providing suggestions for improvement.

2. Exemptions: The business activity tax under this proposal is a goods-and-services tax on a broad base. The more exemptions carved out, the more economic distortions that will exist. That said, many countries exempt from their consumption tax base small businesses with taxable sales below a certain threshold. This proposal will seriously consider such an exemption, in an effort to reduce the compliance and administrative costs for small businesses and the government. Like other exemptions, however, a small business exemption could create distortions. For example, if only larger businesses are subject to a consumption tax, those businesses might be incentivized to outsource work to exempt small businesses and/or to treat payments that would otherwise be nondeductible wages as deductible payments to third parties. Thus, we are interested in receiving feedback on the contours for this type of an exemption, as well as rules that might be necessary to reduce opportunities for abusive tax planning. We are also interested in receiving feedback on the pros and cons of exempting other types of commercial activities exempted in certain other countries, such as leasing of real

property and supply of land and buildings. Additionally, because the U.S. currently imposes a type of consumption tax on a number of goods (e.g. excise taxes), we seek feedback regarding the need, if any, to harmonize existing excise tax regimes with the business activity tax.

3. <u>Pass-through Entities</u>: The proposal contemplates that pass-through entities will have the option to be treated as separate entities subject to the same tax rules as C corporations. We welcome feedback on what, if any, additional rules would be needed to facilitate this option. We also recognize that pass-through businesses with losses might choose to retain their pass-through status to offset individual income. C corporations are not (and would not) be allowed to offset corporate losses against individual income. To help ensure consistent treatment of operating losses for owners of flow-through businesses and C corporations, we are interested in receiving feedback on rules to determine the extent that pass-through losses should be allowed to offset non-business ordinary income.

4. <u>Accumulated Earnings</u>: Repealing the corporate tax, while taxing all character of income equally at the individual level, could create an incentive for individual taxpayers to accumulate passive investment income in the corporate form as a tax-avoidance mechanism. While special rules exist to deal with this issue under current law, such as the personal holding company tax and the accumulated earnings tax, we are interested in receiving feedback on whether these rules should be strengthened and/or expanded to ensure that the corporate form is not primarily used to avoid tax on a corporation's shareholders.

5. <u>Reasonable Compensation</u>: Because a corporation would not be permitted to deduct compensation payments in calculating the business activity tax, corporations might have an incentive to minimize compensation paid to an owner for labor services. To the extent that corporations would characterize what is truly labor income as capital income, this would impact the Social Security and Medicare trust funds. Thus, we are interested in receiving feedback on changes needed to the reasonable compensation rules in this context.

6. <u>Distributional/Age Issues</u>: While broad-based consumption taxes are often thought to be inherently regressive, this proposal directly counters this notion in a number of ways (e.g. significant increase in the standard deduction, and significant expansion of the 10% bracket

and Earned Income Tax Credit). It is also acknowledged that fixed income taxpayers would not benefit from an expanded EITC. Our understanding, however, is that Social Security and other major government benefit programs are currently indexed to reflect the price of goods and services. Thus, to the extent that the price of goods and services do increase under this proposal, taxpayers receiving Social Security and other similar federal benefits would see a corresponding increase in their benefits. That said, we are still interested in feedback on whether there are other unique interests of fixed-income taxpayers that need to be accounted for in transitioning to a goods-and-services tax.

7. <u>Implications for State and Local Governments</u>: Eliminating the corporate income tax and replacing it with a national-level business activity tax would impact the revenue model of State and Local governments. Those jurisdictions would likely consider whether to conform their tax bases to the federal base, both for retail sales taxes and state corporate income taxes. While the Canadian model is informative on how a federal goods-and-services tax can interact with state-like jurisdictions (i.e. provinces) that already impose a sales tax, we seek feedback regarding how the federal government could facilitate conformity for States, if a State chose to do so.

8. <u>Concerns About Government Growth</u>: While evidence is not conclusive regarding whether a national-level goods-and-services tax does facilitate the growth of the government, some fear that such a tax would allow the government to raise money too easily without proper transparency. While Congress has had great difficulty raising taxes deemed to be regressive (e.g. consistently rejecting inflation adjustments to gas and diesel user fees and instead using budgetary gimmicks to provide short-term funding for the Highway Trust Fund), we are nonetheless very sensitive to this concern. While the proposal contemplates including a circuit breaker similar to the one included in Senator Cardin's Progressive Consumption Tax, which returns overages to taxpayers when revenues exceed predetermined levels, we are interested in receiving feedback not only on how to make the business activity tax transparent but also on preventive measures to deter future Congresses from irresponsibly raising it.

9. <u>International</u>: Repealing the corporate income tax will dramatically increase the competitiveness of U.S.-based companies on a worldwide basis as well as strongly encourage

foreign direct investment. Moreover, implementing a single-digit border-adjustable goods-and-services tax that operates similar to consumption tax regimes adopted by every other OECD country means there should be no questions regarding whether it is WTO-compliant. We do seek feedback, however, on how this proposal might be impacted by either action items from the OECD's Base Erosion and Profit Shifting (BEPS) project or legislation implemented by OECD countries adopting BEPS recommendations.

10. Foreign Shareholders: Foreign shareholders currently own approximately one-quarter of U.S. stock. Whereas the federal government can tax U.S. shareholders of corporations that do business in the U.S. through the individual tax system, the corporate income tax is one of the only ways for the federal government to raise revenue from foreign shareholders of corporations that do business in the U.S. Thus, to the extent that some of the burden of the corporate income tax falls on shareholders, repealing the corporate income tax will cause the federal government to lose revenue from nontaxable foreign shareholders of corporations that do business in the U.S. To address this issue, we seek feedback on what mechanisms, if any, should be considered (other than provided by current law and treaties) to remedy this issue—while balancing whether such mechanisms would shift potential foreign investment away from the U.S. to another jurisdiction.

11. Transition Rules: One of the biggest issues where work still remains is with respect to transition rules. While noting that generous transition relief could significantly increase the cost of this proposal in a manner that might require a higher single-digit business activity tax rate (which would reduce the proposal's economic benefits), transition relief will be needed in a number of areas. While we welcome any transition-related suggestions, areas of particular interest on the individual side include: (1) addressing cash flow timing difference in the first year between the incidence of the consumption tax and when low-to-middle income taxpayers receive return-related tax credits (e.g. should there be a one-time up front rebate for these taxpayers based on prior year taxable information?); (2) sales of consumer durables; and (3) making the transition fairer for older taxpayers. On the business side, (1) suggestions on the mechanics of applying unused depreciation against the business activity tax; and (2) treatment of unused net operating losses or credits (including foreign tax credits) accumulated prior to enactment of the business activity tax.

[i] Larry Kudlow, *This is a war on tax inversions*, cnbc.com (Apr. 5, 2016), *available at* http://www.cnbc.com/2016/04/05/this-is-a-war-on-tax-inversions-kudlow-commentary.html.

[ii] It's acknowledged that a national-level business consumption tax as a replacement for the corporate income tax isn't a completely new idea. *See*, *e.g.*, Roadmap for America's Future Act of 2010, H.R. 4529, Sec. 602, 111th Cong. (Rep. Paul Ryan); Roadmap for America's Future Act of 2009, S. 1240, Sec. 602, 111th Cong. (Sen. DeMint); Office of Tax Policy U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Chapter II Replacing Business Income Taxes with a Business Activity Tax (Dec. 20, 2007).

[iii] Jeremy Scott (quoting Prof. Michael Graetz), *Does the United States Really Need a Tax Revolution?*, Forbes.com (Feb. 25, 2015), *available at* http://www.forbes.com/sites/taxanalysts/2015/02/25/does-the-united-states-really-need-a-tax-revolution/#7c4970a8489f.

[iv] Michelle Hanlon, *What to say to constituents about potentially cutting the corporate tax rate?*, The Hill (Mar. 17, 2016) ("Thus, when asked whether it is fair that big corporations (the proverbial 'they') get a lower rate than individuals (the proverbial 'us'), it is first important to understand that it is not them against us: they are us.").

[v] Megan McArdle, *Why We Should Eliminate the Corporate Income Tax*, The Atlantic (Oct. 28, 2010) ("I can practically hear my more leftish readers grinding their teeth as they prepare to unload a wagonful of vitriol, but my objectives here are as much liberal as they are conservative. The corporate income tax is an extraordinarily clumsy vehicle for the social purposes it is supposed to serve--it doesn't raise that much revenue, and it doesn't necessarily fall most heavily on the rich.").

[vi] To discourage future Congresses from reinstating the corporate income tax, SATS intends to include in legislation a 60% threshold to do so.

[vii] Kyle Pomerleau, *Eliminating Double Taxation through Corporate Integration*, Tax Foundation (Feb. 2015) ("Ideally, business tax reform would bring all business income under the same tax code. This way all business income is taxed once at the individual level and treated equally, regardless of legal form.").

[viii] Indeed, "[a]s the Gulf States Cooperation Council prepares to introduce a VAT in the next few years, North Korea, Somalia, the U.S. will be among the few remaining countries without a national-level VAT." Timothy H. Gills & Harley T. Duncan, *Will The United Stated Adopt a Value Added Tax?*, Bloomberg BNA Tax Planning International, at 4 (June 2016).

[ix] *See* Progressive Consumption Tax Act of 2014, S. 3005, 113th Cong. (Sen. Cardin). Indeed, Senator Cardin has published a very thoughtful FAQ on consumption taxes generally, available at https://www.cardin.senate.gov/pct-faq.

[x] *See, e.g.*, Bruce Bartlett, *The Conservative Case for a VAT*, Tax Analysts (2011) ("The VAT … creates less economic distortion per dollar of revenue than any other tax — certainly much less than the income tax.").

[xi] *See generally* Itai Grinberg, *Where Credit Is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT*, 63 Tax L. Rev. 309 (2010).

[xii] *Id.*

[xiii] *Id.*

[xiv] *Id.*

[xv] SATS presupposes the 3.8% net investment income tax will be repealed as part of broader healthcare reform.