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United States

New Faces Bring Hope for Tax Overhaul, But Thorny Cost Estimate Issue Threatens

The international debate over base erosion and profit shifting and the debate over restructuring the U.S. international tax system have often run on two parallel, but interrelated paths.

But while the Organization for Economic Cooperation and Development appears close to presenting concrete proposals on BEPS, even with a new Congress in place, the U.S. debate over tax reform remains as theoretical as ever.

''There's probably going to be a lot of talk. There always is,'' said Eric Toder, co-director of the Tax Policy Center, a program of the Urban Institute and Brookings Institution. ''Tax reform is something everybody's for, except when you get to the details—then nobody's for it.''

If Congress were to overhaul the tax code, it could lead to a reduction in the corporate tax rate, a change in philosophy behind the U.S. worldwide tax system, and possible tweaks to Subpart F to capture intangible-related income generated in low-tax jurisdictions. But specifically what the changes would look like and how they could come about remain an open question to observers and practitioners, and many still peg the chances as being slim.

Despite the uncertainty, however, there is still huge pressure on Congress to change the U.S. tax code. Corporations claim high rates and complex laws make them unable to compete globally.

In addition, growing concern about BEPS-related issues has put pressure on Congress to close alleged loopholes in the international tax system. In 2014, inversions—such as Burger King's merger with Tim Hortons Inc. to establish Canadian tax residency—caused a public outcry and became a political flash point. But Republicans and Democrats came nowhere close to a deal to change the laws, with many Republicans claiming that a comprehensive tax overhaul is the only appropriate way to deal with companies looking to leave the U.S. tax system.

Camp's Work. In 2014, Rep. Dave Camp (R-Mich.), then chairman of the tax-writing House Ways & Means Committee, released a comprehensive plan, dubbed the ''Tax Reform Act of 2014,'' after nearly three years of work and hearings. The revenue-neutral plan would end worldwide taxation and create a new Subpart F category for ''intangible-related'' income, which would be taxed at an effective rate of 15 percent (22 *Transfer Pricing Report* 1315, 3/6/14).

Camp's Subpart F provision as similar to individual proposals which had been included in budget requests from the White House. The apparent common ground gave hope that there might be some path for a compromise proposal. But despite the similarities of some ideas, the parties remain starkly divided overall. A proposal from Sen. Max Baucus, D-Mont., then chairman of the Senate Finance Committee, would not only have retained worldwide taxation, but it would have ended deferral for a majority of off-shore earnings.(22 *Transfer Pricing Report* 1311, 3/6/14).

Camp's proposal received pushback from his own party, and ultimately it did not go anywhere in the 113th Congress. Democrats remained wary of a comprehensive tax plan that did not raise new revenue—a non-starter for the GOP—while some conservatives balked at some of the proposals included in Camp's plan, such as a new tax on financial institutions.

New Faces. A new Congress, however, is bringing in new faces to the discussion.

Camp and Baucus are both gone from Congress. Camp was replaced by Rep. Paul Ryan, (R-Wis.) as chairman of Ways a Means. Ryan is a well-known figure as the Republican nominee for vice president in 2012 and former the chair of the House Budget Committee.

After the Republican party won back the Senate in the November elections, Sen. Orrin Hatch (R-Utah) was elevated from ranking member to chairman of the Senate Finance Committee. Hatch had been involved in the discussions over international taxes before, but now will hold a more central post in the debate.

The changeover has given hope that a fresh start might lead to some new compromises. But it has also created the possibility that, setting the rules of a new debate—such as the revenue target and how the legislation would be scored—may end up stalling the discussion before it ever gets to the substance of the issues.

Their Own Imprint. The change in faces has left observers wondering where the process stands. Is Camp's plan still the blueprint for a Republican proposal?

''I would expect Paul Ryan and Orrin Hatch to use this opportunity to put their own imprint on tax reform,'' said Ray Beeman of Ernst & Young LLP, who worked as tax counsel for Ways and Means under Camp and helped craft his proposal. ''[Ryan] considers the Camp draft to be a marker, not a starting point. He's

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already indicated that the draft will continue to inform the debate.''

In December, Hatch released a report—''Comprehensive Tax Reform for 2015 and Beyond''—which was an overview of the discussions so far. More descriptive than prescriptive, the report was spare on specific policy proposals. However, it did include strong support for a territorial system.

''Put simply, the United States needs to adopt a territorial type of tax system,'' the report states.

A few days later, Hatch outlined, in a speech on the Senate floor, what he dubbed his ''seven principles for comprehensive tax reform.'' Those principles included revenue neutrality and ''competitiveness''—which, he said, would require a shift away from a worldwide system toward a territorial one.

The parties do not show any signs of moving towards a consensus on whether the U.S. should continue to tax worldwide income, or if it should join most Western nations in implementing some sort of exemption regime.

''I don't see anything from the administration that says they're willing to do that,'' said Toder of the Tax Policy Center, on moving to a territorial system. ''They're going in the other direction. They're trying to move more in the direction of a worldwide tax.''

Others are more optimistic.

''There is really nobody calling for a pure territorial system,'' said Jonathan Traub, a former staff director of Ways and Means, now with Deloitte. ''We don't have a pure worldwide system now. The question is how far you move the needle towards a territorial system. I think in the past, we've seen some openness from the administration on that.''

Cost Estimates. What might derail the negotiations before they even get started, however, is figuring out how much it should cost.

Republicans have largely embraced ''dynamic scoring,'' the principle—so far not used by the Congressional Budget Office or the Joint Committee on Taxation—that the cost estimate for tax legislation should include estimates of changes to the gross domestic product. Conservatives support this approach not only because it matches with their ideology that higher taxes hinder the economy, but because it would make tax cuts easier to pass while adhering to revenue neutrality.

Democrats are cool to the concept, claiming it substitutes real lost revenue with questionable promises of future growth. And, many have noted, if it should be applied to tax cuts, why wouldn't it apply to increased spending—which also has an effect on GDP—as well?

''They would love if you had dynamic scoring on infrastructure spending, or education, or something like that,'' Toder said.

The view was summed up by former Treasury international tax counsel David Rosenbloom, now with Caplin & Drysdale in Washington, D.C., in a letter to the editor of the Washington Post.

''I think 'dynamic scoring' of tax measures is a terrific idea,'' Rosenbloom wrote. ''I can't wait to see the score attributable to the underfunding of the Internal Revenue Service.''

Republicans have already moved on the issue, implementing a rule in the House that requires consideration of macroeconomic effects for major legislation. They've also blocked the reappointment of Douglas Elmendorf to be director of the CBO.

However, Hatch and Ryan both agreed to retain Thomas Barthold as director of the Joint Committee, which typically scores tax legislation. The JCT has said it uses ''non-static'' scoring, but does not include in its cost estimates predictions of changes to the GDP.

Whether or not the macroeconomic effects of taxing or spending legislation can be accurately predicted is a question for accountants and economists. How those predictions should affect legislation is, on the other hand, a policy and political consideration.

''No business is going to succeed if it bases its decisions on what its accountants tell them,'' Toder said. ''Policy judgements are not made by accountants or scorekeepers.''

Windfall. Whether to include dynamic scoring is not the only sticky issue when it comes to cost estimates.

There's also the question of how to include the initial windfall of overseas cash that would likely accompany a major tax overhaul. Both the Camp and Baucus plans include provisions to bring back corporate earnings currently being deferred off-shore as a reduced rate, as part of the transition.

Camp's plan would include that windfall in its overall revenue estimate, which was ultimately revenue-neutral—even though the windfall would only occur once, but the changes in the tax law would be permanent.

President Obama, on the other hand, suggested in November that the windfall could be used to fund infrastructure projects. And earlier in 2014, then-Senate Majority Leader Harry Reid and Sen. Rand Paul, R-Ky., proposed using a one-time tax holiday—not tied in with overall reforms—as a way to shore up the Highway Trust Fund without raising the gas tax.

That proposal was not ultimately used, but lawmakers are again looking for ways to cover an expected shortfall in the fund. On Jan. 15, Ryan ruled out an increase in the gas tax.

Wrangling over revenue estimates and costs is typical for Washington legislation. But some observers worry that it ultimately distracts from the more important issue—the changes to the tax code.

''That's often the unfortunate outcome of having a kind of revenue estimate-driven tax legislative process,'' Beeman said. ''The focus on the revenue effects can mask the basic question of whether or not you're doing good policy. In some cases, it can put the cart before the horse.''

The White House has issued several proposals related to international corporate taxation within its budget proposals, and in 2012 issued an outline for a comprehensive tax overhaul, including a minimum tax for overseas profits.

The president has also stepped up the rhetoric on taxes, laying out proposals in his State of the Union address for a series of revenue raisers—including a hike in the capital gains tax rate—to pay for new domestic initiatives, including a plan to expand access to community college.

The address included vague references to the international tax system.

''Let's close loopholes so we stop rewarding companies that keep profits abroad, and reward those that invest in America,'' Obama said.

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But many observers have said the lack of a clear, detailed tax overhaul plan from the White House is stymieing the chances for action from Congress.

''The administration has never put forward a comprehensive tax reform plan. They have not indicated what they would do. They have not developed a blueprint,'' Toder said. ''There's nothing like the fully articulated plan that [former President] Reagan introduced in 1985.''

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