"Tax Reform is Impossible –
Until it is Inevitable"

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The Washington Update

The above quote, paraphrasing Milton Friedman (no relation), seems apt. Earlier this year we received the first comprehensive tax reform proposal from Washington since Ronald Reagan's presidency. The proposal comes from Representative David Camp, the Republican chairman of the Ways & Means Committee, the tax-writing committee of the House of Representatives. This white paper discusses Camp's proposal, the need for tax reform, and the barriers that stand in the way of its enactment.

Why is tax reform so hard?

"Tax reform" typically means rewriting the tax code to remove loopholes, simplify the rules, eliminate the alternative minimum tax, and lower tax rates. So stated, tax reform is a no-brainer. Virtually everyone agrees the tax code is far too complex, and most people approve of lower tax rates. Both parties favor it in concept.

Yet, it is said in Washington, "tax simplification is complicated stuff." (The quote is from Pamela Olson, former assistant Treasury secretary for tax policy.) There are a number of hurdles a tax reform proposal must overcome. First, there must be agreement on whether the proposal is to raise revenue. Democrats demand that tax reform be used to increase the total tax revenue the government receives. Republican's believe tax reform should be "revenue neutral", that is, bring in the same overall revenue but through a simpler tax code. The last time the United States implemented tax reform, in 1986 under Reagan, the plan was revenue neutral. Camp's plan, too, purports to be revenue neutral.

Second, the tax reform plan cannot favor the wealthy. Because wealthy taxpayers typically have the most taxable income, they save the most in taxes when tax rates are reduced. If the wealthy save taxes and the overall reform plan is to be revenue neutral, then middle- and lower-income taxpayers must pay *more* taxes to make up the difference. A plan that lowers taxes on the wealthy and raises them on the middle class is not viable politically. Adjustments must be made.

Finally, to keep a plan revenue neutral, the revenue lost from a reduction in tax rates must be recouped by eliminating or curtailing "sacred" deductions and exemptions that we have come to expect and rely upon. Items like the mortgage interest deduction and tax-exempt interest on bonds must be on the table for consideration. Most of these items have strong support from particular industries or groups, making it difficult for Congress agree to enact changes to them.

The Camp Proposal

Representative Camp's proposal illustrates the difficulty of fashioning a far-reaching reform proposal. Camp nominally would reduce the top individual tax rate to 25% (from the current rate of close to 45%). But then Camp would add a ten percentage point surtax to the extent a family's income is above $450,000, in effect raising the top tax rate to 35%. More controversially, the 10% surtax would apply to income of virtually *all* types, including interest on municipal bonds and employer-provided health insurance. This structure assures that the wealthy do not benefit unduly from the drop in tax rate. (The 35% tax rate does not include the additional 3.8% tax on investment income under Obamacare, which Camp retains.)

Camp also curbs or eliminates deductions to recoup the revenue lost from the lower tax rate. Among many others, Camp would make the following changes:

- Mortgage interest paid would be deductible only to the extent of $500,000 of debt on a principal residence. Under current law, interest is deductible to the extent of $1 million in mortgage debt.

- The deduction for state and local taxes would be eliminated entirely.

- Charitable contributions would be deductible only to extent they exceed in the aggregate two percent of adjusted gross income.

- Half of all 401(k) contributions would be treated as made to Roth accounts. To the extent so treated, contributions would be non-deductible, but post-retirement earnings could be withdrawn tax free.

- The alternative minimum tax would be repealed.

- The current estate and gift tax rules, and tax-deferred build-up on life insurance and annuity policies, would remain unchanged.

Camp also addresses the corporate tax system. He would reduce the corporate tax rate to 25% (from the current 35%) and recoup the lost revenue from a number of changes, including:

- The modified (enhanced) accelerated depreciation system would be repealed.

- The last-in-first-out (LIFO) accounting for inventories would be repealed.

- Earnings currently held offshore would be *deemed* to be repatriated and subject to an 8.75% tax. The tax would apply regardless of whether past earnings actually are repatriated. The imposition of this tax likely would encourage companies to repatriate foreign earnings as there would be no additional tax cost to doing so.

- As under current law, future offshore earnings would be taxed only when repatriated, but under a two-tier tax system:
  - Offshore earnings associated with manufacturing and other active business operations would be taxed at a 5% rate when repatriated.
  - Other offshore earnings (deemed to be from the exploitation of intangible assets) would be taxed at a 15% rate when repatriated.
- A new asset-based tax would be imposed on large financial institutions.
- 70% of earnings received by employee-owners of pass-through entities would be subject to employment taxes. This change seeks to curb what many in Washington perceive to be a loophole. Currently, some employee-owners of pass-through entities (such as S corporations) treat a portion of their share of earnings as wages subject to employment taxes and a portion as dividends not subject to employment taxes. Camp's proposal would treat 70% of such earnings as subject to employment taxes. (President Obama has proposed that 100% of such earnings be subject to employment taxes.)

Congressional Reaction

Many of Camp's proposals to raise additional revenue -- such as the tax on municipal bond interest and the asset-based tax on financial institutions -- mirror proposals made by the Obama administration. (Obama, however, would use the resulting revenue not to finance tax reform but to offset the cost of new government programs.) For that reason, as well as the fact that many of Camp's proposals are quite controversial, most Hill Republicans have distanced themselves from Camp's plan. Democrats also have criticized the plan as failing to raise additional revenue and unduly favoring wealthy taxpayers.

With the midterm elections approaching, it is clear that Congress will not take up Camp's proposal -- or tax reform in general -- this year. Next year, Congress is likely at least to consider tax reform. Camp is retiring this year, likely to be replaced as Ways & Means chairman by Paul Ryan, the former vice presidential candidate. In his budget proposals, Ryan has expressed great interest in tax reform. The tax-writing committee in the Senate will be led by Senators Wyden and Hatch, both of whom also have expressed interest in tax reform.

At this very early stage it appears that individual tax reform is probably too heavy a lift for Congress. In the polarized environment of Washington, it is hard to see Congress agreeing on such controversial proposals as taxing municipal bond interest or limiting charitable contribution deductions. Tax reform would have a far better chance if the White House made it a top priority and put its powers of persuasion behind it (as Reagan did), but past inaction by the Obama administration suggests that is unlikely.

I have a bit more hope we might see corporate tax reform in the next few years. The United States has the world's highest corporate tax rate, which has prompted U.S. businesses to move operations (and jobs) overseas. This year Pfizer made a bid (since withdrawn) to take over Astra Zenica in part for the taxes Pfizer would save by moving its headquarters from the United States to London. Last year the CEO of Apple testified how his company has radically reduced taxes by moving operations outside the United States.

There is a bipartisan consensus in Washington that a reduction in corporate tax rates is needed to encourage companies to keep operations and jobs here. Even the President has expressed a willingness to undertake corporate tax reform on a revenue neutral basis. It will not be easy, however. To maintain revenue neutrality, a significant drop in the tax rate must be accompanied by elimination or curtailment of deductions upon which particular industries rely, such as oil and gas depletion allowances, LIFO accounting (important to the retail industry), accelerated depreciation (important to the manufacturing sector), and asset based taxes (anathema to the financial sector). Representatives from these sectors will put pressure on Congress not to adopt changes that adversely affect their clients. Yet, absent such changes, the lower tax rate that is crucial to tax reform cannot be achieved.

In short, tax reform does not appear inevitable yet. We'll learn more next year, and I will keep you posted.

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