JOINT ECONOMIC COMMITTEE
SENATOR DAN COATS, CHAIRMAN

Ten Federal Tax Areas Ripe for Reform

Tax reform done well can increase economic growth. There are areas in the tax code that are ripe for reform, including the tax changes imposed by the *Affordable Care Act (ACA)*. The following highlighted tax areas and recommended changes would serve to reduce compliance costs and the financial burden of the current overly-complex and byzantine federal tax code:

- Corporate taxes
- Income taxes on individuals and pass-throughs
- Health insurance coverage taxes
- Taxes on capital gains
- Taxes on dividends
- Estate taxes
- Tax treatment of expensing vs. bonus depreciation
- The “Cadillac tax”
- Medical device taxes
- Implicit tax: Tax compliance costs

Minimal progress has been made on some tax areas over the past several years, but for each of the small beneficial changes that have occurred, such as indexing the Alternative Minimum Tax exemption to inflation, there have been many additional changes that make taxes more burdensome on businesses and their employees, such at the medical device tax and the coming “Cadillac tax” on healthcare plans. Comprehensive tax reform has not been attempted in almost three decades. Americans broadly support major tax reform and have shown a demonstrable willingness to exchange special tax preferences for lower, simpler rates. It is time to refresh and renew the tax code to promote increased productivity, income, and jobs for all Americans.

1. *Corporate taxes*

The United States has the unenviable ranking of highest corporate tax rate in the developed world, the type of tax the Organization for Economic Development and Cooperation (OECD) has found to be the most harmful for growth.[1] Among the 34 advanced economies in the OECD, the U.S. top corporate tax rate stands at 39.1 percent, including the 35 percent federal rate and average state taxes. Research published by the American Enterprise Institute found that both the effective and marginal effective tax rates in the United States are far above those of our OECD competitors, and a recent Tax Foundation study found that the United States has the second-highest marginal effective tax rate of 95 different countries.[2]

Compounding this disadvantage, the United States remains one of the few developed countries that has a worldwide tax system, which subjects all income of multinational companies to U.S. tax once it is brought back to the United States regardless of where it is earned. In fact, 28 of the other 33 countries in the OECD have territorial systems that allow businesses to bring overseas profits back home with little or no tax. Companies have a strong incentive to keep earnings overseas, which reduces the level of investment in the United States. Not only should corporate rates be lowered, but the United States should also move toward a territorial system. This would allow U.S. multinationals to compete more effectively in global markets.

2. *Income taxes on individuals and pass-throughs*

Ninety-five percent of businesses[3] pay taxes at the individual level rather than the corporate level; these businesses are known as "pass-throughs" because income earned by the business is treated as income of the investors or owners. They account for more than 60 percent of all business income, and more than half of all employment.[4] According to the aforementioned OECD study, income taxes are the second most harmful tax for economic growth. When President Obama took office, the top federal tax rate paid by small businesses was the same as the top rate paid by C corporations, at 35 percent. Since then, the top rate for pass-throughs has increased at the President's insistence to 44.6 percent from a combination of rate increases and taxes associated with the *Affordable Care Act*.[5]

The Congressional Budget Office (CBO) finds that even with only a single level of tax at the pass-through level, compared to the double tax that C corporations face at the corporate and shareholder levels, pass-throughs only receive a four percent lower effective tax rate than C corporations.[6] High individual income taxes unduly burden successful pass-through companies, entrepreneurs, innovators, and other highly-productive labor. As such, lowering individual income taxes would benefit pass-throughs as well as American families. Concurrently, elimination of various credits and deductions that give preference to certain industries over others would treat businesses and individuals on a level playing field and reduce distortions in specific business activities that would not occur in absence of preferential tax treatment.

3. *Health insurance coverage taxes*

The ACA established a series of new unprecedented taxes on health care services and products. Although they tax different forms of income, as shown throughout this document, this particular section focuses on the tax paid relating to health insurance coverage. The ACA mandates employers with 50 or more full-time-equivalent workers pay a $2,000 tax (per full-time worker) if they do not offer minimum essential coverage to at least 95 percent of full-time workers and at least one full-time worker receives a premium subsidy; or pay a $3,000 tax (per full-time worker with a subsidy) if they do offer minimum essential coverage and at least one full-time worker receives a premium subsidy. The Obama Administration waived these taxes for all employers in 2014, and has applied them only to employers with 100 or more full-time-equivalent workers in 2015, so the full impact of this mandate will likely be seen in the coming years.[7]

The effects of ACA-related taxes do not end with employers. The ACA also requires individuals to obtain health insurance coverage or pay a tax equal to the greater of: $95 or 1 percent of income in 2014; $325 or 2 percent of income in 2015; or $695 or 2.5 percent of income in 2016 and beyond. Some individuals may choose to pay the tax rather than purchase subsidized coverage, but this result becomes less likely as the taxes continue to rise in the future. The taxes and subsidies contained in the ACA will continue to discourage full-time employment and encourage part-time employment and non-employment. These effects will only become apparent over time as the ACA provisions are fully phased in. Repeal and replacement of the ACA would prevent this collection of taxes from adversely affecting economic growth and job growth.

4. Taxes on capital gains

Taxes on capital gains reduce capital formation, which in turn, lowers growth in productivity and wages, and slows the growth of employment. These three issues were at the very heart of the concerns the Administration expressed in this year's *Economic Report of the President*. However, under President Obama, the top rate on capital gains has already risen by almost 60 percent, from 15 percent to 23.8 percent when ACA taxes are included.[8] The top effective tax rate is now 43.4 percent for short-term capital gains, interest, and non-qualified dividends.[9] When both corporate and individual taxes are included, the Administration's tax increases have earned America the second-highest integrated capital gains rate in the OECD at 56.7 percent, behind only Italy.[10]

America has experimented with high capital gains rates before, and it was a failure. After the capital gains tax rose to 28 percent in 1987, sales of capital assets sank and remained depressed until Congress lowered the capital gains rate to 20 percent in 1997.[11] Capital gains are already subject to multiple layers of taxation. In addition, a lower rate on capital gains at the individual level mitigates the effects of inflation which can erode the actual economic gain from selling an asset. Higher capital gains tax rates not only raise the cost of capital, which is the required rate of return on an investment for a firm or individual to choose to invest, but also slow worker productivity growth through reduced investment in new software and equipment. This also makes businesses less competitive in the global market, where many corporations based in other countries enjoy higher returns as a result of lower capital gains rates. Lower taxes on capital gains would remove the additional layer of tax at the individual level after corporate taxes are paid, lower the cost of capital for businesses and individuals to invest, and improve U.S. businesses' competitiveness internationally.

5. Taxes on dividends

Income from investments, whether in the form of dividends or realized capital gains, are typically subject to the same tax rate to ensure that one form of investment is not unfairly advantaged over another. Like the capital gains tax, the tax on dividends is an additional tax on the same dollar of income. After corporations pay up to nearly half of the value of profits through the corporate income tax, the distributed profits left over are taxed again at the individual level, taking up to nearly another quarter of the remaining investment income via the dividend tax. The tax burden on dividends creates a bias against savings and investments, motivating individuals to consume now rather than save. As such, the distortion results in less investment and capital available for future growth.

Furthermore, the tax treatment of profits also distorts how companies finance their expansions. A December 2014 CBO report found that equity-financed C corporation investments faced an effective tax rate of 38 percent, compared to debt-financed investments of minus 6 percent, effectively a subsidy. For pass-throughs, these effective tax rates were 30 percent on equity-financed investments and 8 percent for debt-financed investments.[12] Further, a 2007 Treasury Department report noted that the United States has the largest disparity between debt and equity marginal effective tax rates in the OECD.[13] Like capital gains, dividends are also subject to the ACA's additional 3.8 percent tax, raising the top rate for qualified dividends to 23.8 percent. Dividend-paying stocks are disproportionately owned by retirees and near-retirees, meaning that many that fall into these age groups have been subject to higher rates in recent years, living on smaller incomes. Lowering the dividend tax as well as the capital gains tax would eliminate the extra layer of tax on savings and investment.

6. Estate tax

The estate tax remains a contentious tax in the Internal Revenue Code. In addition to taxes that are paid on wages, corporate income, and capital gains and dividends, the estate tax adds yet another burdensome layer on savings and investments at the time of the benefactor's death. Many studies, including previous works from the Joint Economic Committee (JEC), confirm that the cost to comply with the tax exceeds the federal revenue raised from it.[14]

Among the findings of the JEC study, the estate tax was cited as a significant hindrance to entrepreneurial activity. A large number of family farms and other family-owned businesses have illiquid assets such as land and equipment that could be subject to costly estate taxes, potentially forcing farm families to sell land, farm machinery, and livestock just to cover the tax. Repeal of the estate tax would provide greater certainty, fairer treatment in the tax, and reduced cost of compliance.

7. Tax treatment of expensing vs. bonus depreciation

In years past, Congress has extended bonus depreciation that allows extra first-year deductions for equipment purchases at levels of 30 percent, 50 percent, or even 100 percent. This ameliorates the tax burden on businesses making large equipment investments. In addition, Congress has temporarily expanded the amount of equipment purchases that small businesses can fully expense in the year of purchase. Given the temporary nature of these tax provisions, many businesses face uncertainty in the decision to invest in new equipment from one year to the next. Permanent full expensing, however, which allows businesses to deduct the full cost of newly purchased equipment in the year purchased, would be a welcome treatment for businesses that are planning to buy equipment. Under full expensing, businesses deduct more in the year of equipment purchase, as they do with spending on employee wages, and deduct less in subsequent years after the purchase.[15]

As former Council of Economic Advisers Chairman Ed Lazear notes, although lowering corporate rates reduces taxes for both old and new capital, full expensing is more effective at stimulating new investment.[16] The Tax Foundation finds that full expensing on a permanent basis would boost GDP by more than five percent, capital stock by more than 15 percent, and create nearly one million additional jobs.[17] Unlike temporary tax advantages offered to specific business activities, full expensing would benefit a broad range of industries and remove the existing distortion of depreciation that alters the timing of tax payments. However, even extending bonus depreciation on a permanent basis is estimated to increase GDP by more than one percent, capital stock by more than three percent, and create hundreds of thousands of jobs.[18] Given the constraints to keep reform revenue-neutral, bonus depreciation still confers some of the economic benefits that full expensing offers.

8. The "Cadillac tax"

Although individuals and businesses are already subject to taxation related to health insurance coverage as previously discussed in this document, a new, unprecedented and particularly steep federal excise tax on health insurance is soon to burden businesses and their employees.

In addition to the taxes levied by the ACA in other areas of the tax code, in 2018 the ACA will impose what is known as the "Cadillac tax," a 40 percent excise tax on employers who provide high-cost benefits through an employer-sponsored group health plan. The tax is applicable to the premiums paid by employers, employees and their contributions to Health Care Flexible Spending Accounts, Health Reimbursement Accounts, and Health Savings Accounts. The tax is expected to generate revenue necessary to finance the expansion of health coverage.[19] The thresholds for the tax to kick in start at $10,200 for singles and $27,500 for families. According to a recent survey by Mercer, if employers make no changes to their plans, roughly one-third of employers will be taxed in 2018, and by 2022, nearly 60 percent will be.[20] Repeal of the "Cadillac tax," or the ACA in total, would prevent this additional burden from occurring.

9. Medical device taxes

The 2.3 percent tax on medical device manufacturers and importers is yet another tax imposed by the ACA. Although it is an excise tax, it is a percent of the sales price rather than a flat per-unit tax like those levied on cigarettes and alcohol.[21] Taxable medical devices include any device "intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment, or prevention of disease..."[22] Many common medical devices, such as pacemakers and defibrillators, are subject to the tax, raising their costs to consumers.[23]

Compliance is complex and often costly as businesses attempt to determine the basis of the sales price for such devices. And because the tax is based on sales price rather than profit from the sale, it is particularly harmful to small companies struggling to launch new lifesaving devices that are not yet profitable. Repeal of the device tax or the ACA would prevent this tax from unduly burdening medical device manufacturers and importers, prevent the loss of jobs and innovation, and prevent cost increases to consumers in need of the devices.

10. Implicit tax: Tax compliance costs

Tax compliance is a burden to taxpayers and its value in time and cost does not add to federal revenues. Using IRS sources, the Tax Foundation estimated that Americans spent 1.35 billion hours filing individual taxes, paying $4.4 billion in compliance costs, and spent 1.65 million hours filing business taxes, paying another $12.6 billion in compliance costs.[24] The burden of tax compliance can fall especially hard upon smaller businesses. Nearly half of the small businesses surveyed by the National Small Business Association (NSBA) responded that they spend more than $5,000 annually on the administration of federal taxes, and another 28 percent reported more than $10,000, even before accounting for the actual taxes paid. The NSBA survey found that 67 percent of respondents support reducing both corporate and individual tax rates and reducing business and individual deductions.[25]

The NSBA survey results conclude that principles of tax reform should include: taxing only once; stability and predictability; visibility to the taxpayer; simple administration and compliance; promotion of economic growth and fairness between large and small businesses; use of commonly understood finance/accounting concepts; grounding in reality-based revenue estimates; fair treatment of all citizens; and transparency.[26] If implemented, such recommendations would go a long way toward a simple, broad and transparent tax code that provides the certainty, stability and competitive edge necessary for American businesses and entrepreneurs to thrive domestically and abroad. Such changes would also free up resources otherwise spent on compliance for investing in equipment that makes workers more productive, expanding job opportunities and raising wages for workers.

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