Title: Tax Reform: Two Views

Subtitle: From above the canopy and on the forest floor

Viva Hammer

is at the Joint Committee on Taxation. These words embody work undertaken for the Committee, but as members of both parties and both houses of Congress comprise the Joint Committee on Taxation, this work should not be construed to represent the position of any member of the Committee or any Member of Congress.

Viva thanks the Chief of Staff of the Joint Committee on Taxation, Thomas Barthold, and her colleagues Robert Russell and Kashi Way.

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I'm going to open my discussion on tax reform with demography because all of life is encompassed by who is born and when and who dies and when and what we do and where we live in between. And I could end right there because I prefer to be brief but other people might say I need to explain where tax fits in and so -

Americans are living longer than we ever imagined and are going to have more healthy years after retirement than they spend in the workforce. I know that because I hike with these retirees and they're as vigorous as I am.[1]

Someone is going to have to pay for 40 years of post retirement hiking. And it's not going to be the hikers because they made their deal with society long ago, when life expectancy was much

[1] For statistics on life expectancy, *see*http://www.nia.nih.gov/research/publication/global-health-and-aging/living-longer. For discussion, *see*http://www.washingtonpost.com/national/health-science/us-life-expectancy-on-rise-but-progress-lags-global-peers/2013/07/10/dff836c4-e8c3-11e2-aa9f-c03a72e2d342_story.html

lower. It's the people who don't get to make the deals who are going to be dealing with the problem that comes of the blessing of longevity, namely the hikers' (not yet voting) grandchildren.

I am still brief but I haven't mentioned taxes because they are implicit in all of this. What I see is a long period of experimentation and many attempts at a solution before we reach the moment when our obligations are so clearly beyond our revenues that there's no way to push off the inevitable of reducing obligations or increasing revenues. America's timing to find as solution is fortunate because every other developed country will hit the problem before us, having lower fertility and/or greater longevity than we do. Relative to Asians and Europeans, Americans die young, and have enough children to replace themselves.[2]

What happens between now and that day of reckoning is like what happens between birth and death: could be any number of things, butis unlikely to be nothing.

Mr. Paul Ryan, the new Chair of the House of Representatives' Committee on Ways and Means has also been the head of the Committee on the Budget and has experience on both sides of the ledger. He is unafraid of coming out with innovative ideas, including entitlement reforms.[3]

The immediate past Chair of the Committee on Ways and Means, Mr. Dave Camp, did a great service to the country by showing how immensely difficult tax reform is. And in his almost

[2] "Americans born in 2010 could expect to live 78.2 years, up from 75.2 years in 1990, but that ranked 27th among the 34 nations considered its economic peers." *Ibid*. Fn 1 *Washington Post*. For Total Fertility Rates in OECD countries showing US to be significantly above the average, see http://www.oecd-ilibrary.org/economics/oecd-factbook-2013/total-fertility-rates_factbook-2013-table9-en
[3]*See*, for example, http://www.politico.com/news/stories/0411/52529.html

thousand page discussion draft,[4] he left the Internal Revenue Code more or less in place; he did not introduce a consumption tax (as our major trading partners have) or do away with the corporate tax. Nevertheless, in order to reduce corporate rates to 25% (which is significantly higher than almost all our major trading partners[5]), and to reduce top individual rates a little, he had to eliminate a slew of popular tax benefits. I remember my young son waking me the morning Mr. Ryan introduced his proposal for a 25% top individual rate and yelling out,"You could barely get the rate to 35%, how on earth are you going to get it down to 25%?"Such things weigh on the minds of teens today, knowing that they are going to have to make up the difference, whatever their elders bargain for.

Indeed, how *are* we going to reduce the corporate rate in line with our trading partners (much less the individual rate)?

Some of those in power in Washington are said to be in favor of business tax reform but not individual tax reform.[6]

Why business reform and not individual reform? Business reform can be framed in terms of competitiveness and efficiency. People make the following claims (which neither I nor the Joint Committee on Taxation are endorsing). Our corporate tax rate is too high compared to our trading partners, domestic businesses are at a disadvantage compared to ones that operate overseas, certain types of activities are unfairly advantaged in the Code and we have to level the

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[4] It is 979 pages.
http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf

[5] http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013

[6] Jason Lane, "Obama administration pushed business tax reform in Congress," *Reuters*, February 3, 2015.

playing field.[7] We want America to have the most business-friendly environment so we can keep producing those things we produce best.

In contrast to the positive outcomes associated with business reform, individual reform gets into the murky ground of fairness, of equity, of inequality and emotions. It may be that the President and Congress wouldn't come to an agreement on individual reform.

But you can't do surgery on the tax code that easily. Businesses are owned by individuals. If you reform business tax you also change the tax on individuals. Then, there are tax provisions that impact both individuals and businesses such as the taxation of financial products. When doing business reform only do you change the financial product rules for business and not for individuals? And then there are provisions that are neither business nor individual, or are both, such as tax laws applicable to charities and pensions. Should they be part of reform? Why? Why not?

There are elements of business reform used to lower the rates that effect individuals. When changing the cost recovery MACRS rules to pay for lowering of the corporate rate, passthrus complain,"Not only do we get no benefit from rate reduction but we're worse off because our cost recovery is being lengthened." Mr. Camp did business and individual reform at the same time because businesses are owned by individuals and you can't segregate the two in a world where the boundaries are blurred, as the increasing use of passthrus for business highlights.

[7] Jason Furman, "Business Tax Reform and Economic Growth," Tax Notes, October 6, 2014; See also Remarks of Secretary Jacob J. Lew at the Brookings Institution, U.S. Treasury Department, January, 21, 2015.

Now something about the process of tax reform, and all lawmaking in America.

It's as messy as eating a grapefruit with your fingers.

Nothing's nailed down till everything's nailed down. For example, Mr. Camp has a whole insurance chapter in his Tax Reform Discussion Draft. A lot of the provisions came from a certain member of the Committee on Ways and Means, and some people might say,"Why don't you just get that part passed on its own?" The same could be said of the financial products piece of the Discussion Draft: it's self-contained enough to pass on its own. But to do true reform, each Member needs something special; even if there are pieces that *could* ride separately, piecemeal lawmaking doesn't get the big jobs done.

Nothing moves till everything's moving.

How do you get Members of Congress invested in tax reform, so that they feel they've gotten something special?

Early in the reform effort, Mr. Camp had lots of ideas. Then he established working groups which had a majority and minority member in charge of a topic area,[8] encouraging Members to educate and excite each other. Our representatives have to understand what their constituents really care about, what other representatives' constituents care about and then be able to trade one thing one representative wants for something someone else wants. That's why nothing's nailed down till everything's nailed down. If powerful Americans are going to give up

[8] http://waysandmeans.house.gov/taxreform/workinggroups.htm

something precious in exchange for the Greater Good, then the rest of us unpowerful Americans better be sure we know what that Greater Good we want is. We have to be bought into the idea of putting everything in motion, having lots of winners and lots of losers and a better outcome for the collective American People in the end.

Americans don't like change. We're the only major country in the world that has not adopted the metric system, clinging to the imperial system.[9] The originator of the imperial system, namely imperialist Britain, moved to metric when I was in primary school there in a prior century.[10] Americans don't like change, unless it's the iPhone. When the marketing is good we love change. The champion of change has to travel across the country, has to explain why we need to do this big messy thing: tax reform. A champion of reform has to have different strategies for different market segments that dream different dreams.

In our jobs as the staff of the Joint Committee, we're often in meetings with large numbers of people, more than would be necessary to get the job done, or we're describing the same ideas over and over to different Members and staff. In private practice, having too many people in a meeting is wasteful of clients'resources. But in Congress, the more people who want to come along, the better, because the goal is to get everyone to feel she or he has participated, has been

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[9] "The metric system has been officially sanctioned for use in the United States since 1866, but it remains the only industrialised country that has not adopted the metric system as its official system of measurement. Many sources also cite Liberia and Burma as the only other countries not to have done so." http://en.wikipedia.org/wiki/Metric_system. Think also of the game of soccer which America is joining after everyone else.

[10] "Although the United Kingdom uses the metric system for most official purposes, the use of the imperial system of measure, particularly for use at home, is widespread and is permitted by the law." http://en.wikipedia.org/wiki/Metric_system

heard, to get every Member to own an idea. Part of our job at the Joint Committee is to educate members so they understand what they're agreeing to.

Congress is terribly modern. Building solutions in groups of people with diverse expertise and points of view is at the forefront of every discovery and revolution today. Here from Howard Becker, Chicago sociologist, jazz pianist, and photographer turned Parisian celebrity."A 'world'as I understand it consists of real people who are trying to get things done, largely by getting other people to do things that will assist them in their project. . . . The **resulting collective activity is something that perhaps no one wanted, but is the best everyone could get out of this situation and therefore what they all, in effect, agreed to**."[11] (emphasis added)[12]

Another perspective comes from the British study on funding science research. "If you want science to deliver for society…you need to support a capacity to understand that society that is as deep as your capacity to understand the science."[13] This can be interpreted both in trying to affect change in Congress and about Congress affecting change in America. It's much much more than the words in the tax Bill. It's about Members of Congress representing the diversity of America collaborating to come up with laws that represent something we all feel we had a say in and agreed to and can live with.

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[11] Howard Becker and Alain Pessin, "A Dialogue on the Ideas of "World" and "Field"," Sociological Forum, June 2006, Volume 21, Issue 2, pp 275-286.

[12]Masayo Takahashi, the Japanese ophthalmologist who's pioneering the use of pluropotent stem cells to cure retinal disease, says so many people helped her get to that point it would be like the credits rolling at the end of a movie http://www.nature.com/news/365-days-nature-s-10-1.16562

[13] "Time for the social sciences," *Nature International Weekly Journal of Social Science*, December 30, 2014, http://www.nature.com/news/time-for-the-social-sciences-1.16621?WT.ec_id=NATURE-20141225.

New research has shown that when a country is becoming democratic and adopting a new constitution, the process can be divided into three stages: drafting, debate, and ratification. Citizen participation at the drafting stage is *the* critical factor in the survival of the constitution and the democracy. Ensuring public "buy in"at the beginning of the constitution-making process is much more important than ratification, pleibiscites, and referenda at the end.[14] This finding applies just as well to reforms in our entrenched democracy, too.

It might appear that Mr. Camp's reform was a waste of time because it wasn't passed into the Tax Code, but nothing could be farther from the truth. Mr. Camp's effort showed us what was possible, using every toolwe have, to reduce rates, broaden the base and leave distribution unchanged. And we're going to have similar exercises in the next years and decades, until we've sifted through what ideas can survive the unbelievable knocking around they get on the Hill. None of this is a waste of time; it adds to the intellectual capital of the Hill staff, the country. If there's an equivalent to pure research in how tax laws can be made, Mr. Camp's reform was it.

And now what about scoring? We have the mandate for macroeconomic scoring and also the option for the Chair to require macro scoring.[15] What about the Senate and macroeconomic scoring? And how is this type of scoring going to play in to the Armageddon where I started, when we don't have the receipts to pay the Medicare bill. Which is of course a mythological problem, but one that we have set ourselves up to solve.

[14] http://www.academia.edu/8042537/When_Talk_Trumps_Text_How_Participatory_Deliberation_on_New_Constitutions_Advances_Democratization
[15] H.Res. 5, January 6, 2015.

Now I'm going to dive right down from the view above the canopy and look at some of the microscopic organisms on the floor of the forest.

The treatment of cross border swaps and other derivatives is something I have been speaking to the American Bar Association and other forums about for almost two years.[16] Lots of people don't like section 871(m) and so we are thinking about alternatives to it.[17] If Congress deleted that code section and didn't want to end up with the same problems that resulted in its enactment, what are some other ways to approach the taxation of derivatives in the international context? And how would these possible new rules interact with section 864, the securities trading safeharbor? After all, derivatives are often derived from values of securities covered by the safeharbor.

First we have to think about sourcing, and whether derivative flows should be sourced to the recipient as they currently are under a regulation published long before the swap market became so important, or whether they should be sourced to the payor.[18] In deciding how to source flows, we must decide what principle to use, and there are two main ones: we could source consistent with the treatment of the underlying of the derivative, and we could source to achieve a policy outcome.

Derivative flows can mimic both capital gains or losses, and dividend or interest income. Capital gains are sourced in exactly the opposite manner from dividend or interest[19] so

[16] Amy Elliott and Lee Sheppard, "JCT Counsel Talks Withholding on Cross-Border Derivative Flows," *Tax Notes Today*, January 9, 2015; William Davis and Amy Elliott, "Tax Reform a Chance to Rethink Swap Withholding, JCT Counsel Says," *Tax Notes Today*, December 8, 2014.
[17] See, for example, American Bar Association, Section on Taxation, "Comments on Proposed Regulations Issued Under 871(m)", October 17, 2014.
[18] Treas. Reg. Sec. 1.863-7.
[19] IRC secs. 861(a), 862(a) and 865.

there is no way derivative flows could mimic both types of underlying flows unless we mandated a carving up of the derivative flows for sourcing purposes which is too complex even for the US tax system.

Taking the policy approach, we could have sourcing rules to encourage or discourage certain behavior, for example,

- encourage investment in US (Do derivatives encourage investment? Do debt or equity investing?)
- reduce cost of capital for US business (Do derivatives reduce US cost of capital? Do debt and equity investing?)
- avoid constraints on cross border capital flows
- collect revenue where there's low elasticity of responsiveness to imposition of tax.

The next question is: if we change the source rule for derivatives, what should be done about avoiding gross-based withholding? How do Treaties play in? We are also mindful of the almost complete indifference of parties to the location of the counterparty and do not want to be noncompetitive with our chief competitors in the derivatives market.

In thinking about cross border derivative taxation, we have to weigh the problems with section 871(m) with the need to modernize the taxation of cross border financial flows more generally, including section 864.

How should our consideration of alternatives to section 871(m) interact with the proposal to mark to market derivatives under Mr. Camp's discussion draft[20] and the President's budget[21]?

[20] Committee on Ways and Means, *Tax Reform Act of 2014*, February 26, 2014, Sec. 3401.
[21] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, pp. 99-101.

What of mark to market, indeed[22]?

Here are some matters we're still mulling over on that subject.

Life insurance companies have been agitated about being left out of the hedging regime under current law and as a result, stuck with straddles.[23] They have 3 legs to their business: the policies which are liabilities, the investments (debt and equities) which they use to pay out their liabilities, and the derivatives which manage the gap. Their derivatives don't fit within the definition of a tax hedge because hedging transactions must hedge ordinary assets or ordinary liabilities or flows.[24] The insurance industry has worked out a way to manage the issue but when we move derivatives to mark to market the problem of hedging rears its head again. So what about converting insurance company investments to ordinary assets? It works for banks, so how about for insurance companies? Mr. Camp's Discussion Draft moves half way in this direction and we're wondering what the effect would be if we moved all the way there. Any thoughts?

Next, how to better manage the difference in treatment of ordinary hedging and capital hedging under mark to market? Ordinary hedging gets a complete pass from mark to market and capital hedging is called a mixed straddle. Under Mr. Camp's Discussion Draft, straddles no longer

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[22] For recent discussions of mark to market, see Alan Viard, "Moving away from the realization principle," Tax Notes, November 17, 2014; Robert N. Gordon, "Is Mark-to-Market Taxation on the Horizon?" *Journal of Taxation of Investments* (2013); David S. Miller, "Toward an Economic Model for the Taxation of Derivatives and Other Financial instruments," *Harvard Business Law Review Online* (2013); YoramKeinan, "Is There Mark-to-Market in Your Future?" *Tax Notes*, April 21, 2014, p. 377; and Viva Hammer, "Making Camp a Marking Man," *Tax Notes*, May 5, 2014, p. 621.

[23]http://www.cov.com/files/Publication/22448cc6-ab92-4dea-8d4b-efa959aefb1e/Presentation/PublicationAttachment/12f7959c-35c6-4499-bb13-fdff0e6292e4/oid6529.pdf

[24] Treas. Reg. Sec. 1.1221-2(b)

need all the punitive results enacted in the 1980s because derivatives (hedges) are marked to market and are ordinary in character, but the underlying investments that are being hedged - the debt and equity and commodities - are still capital. What do we do about matching the treatment of capital assets and hedges? Do we follow the accounting rules which pull the hedged asset into the mark to market regime? Or do we create a whole different system that applies only to tax?

If the Discussion Draft has a book tax conformity rule for identification of ordinary hedging transactions, maybe we should work a bit harder at book tax conformity all around. The accountants have now had more than a decade of experience with strict mark to market of derivatives and it behooves us to sit and learn from them.

Next, what to do with the vexed problem of whether to mark to market derivatives with nonactively traded underlyings. The President thinks one thing and Mr. Camp thinks the opposite. Maybe we should set up a meeting and they can hash it out. In the absence of that, we're open to suggestions. Anyone want to start?