

Hearing Report

From: Squire Patton Boggs (U.S.) LLP

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Subject: House Ways & Means Select Revenue Measures Subcommittee: “Funding Our Nation’s Priorities: Reforming the Tax Code’s Advantageous Treatment of the Wealthy”

I. Executive Summary

On Wednesday, May 12, 2021, the House Ways & Means Select Revenue Measures Subcommittee held a hearing titled “Funding Our Nation’s Priorities: Reforming the Tax Code’s Advantageous Treatment of the Wealthy.”

Overall, Democrats blamed the current tax system for creating dramatic wealth inequality, focusing mostly on the preferential tax treatment of capital gains and what they view as a relatively minor tax burden placed on the wealthiest Americans. Additionally, Democrats championed the tax proposals included in President Biden’s *American Families Plan*, such as repealing step-up in basis and increasing the capital gains tax rate. As part of this discussion, one witness raised the potential of “carryover basis” as a compromise approach. There was also discussion of the role of Internal Revenue Service (IRS) enforcement in addressing wealth inequality, with the point being raised that lower-income taxpayers are audited at higher rates than higher-income – something the *American Families Plan* seeks to remedy.

For their part, Republicans defended the *Tax Cuts and Jobs Act* and argued that it has been successful in driving economic growth. Generally, Republicans argued that the President's proposals would hinder investments that lead to productivity and innovation.

The following witnesses testified at the hearing:

- **Adam Looney**, Professor, Executive Director of the Marriner S. Eccles Institute for Economics and Quantitative Analysis, University of Utah;
- **Jason Oh**, Tax Law Professor, University of California Los Angeles School of Law;
- **Harry L. "Hank" Gutman**, Chief of Staff (Retired), Joint Committee on Taxation;
- **Chye-Ching Huang**, Executive Director, New York University Tax Law Center; and
- **Chris Edwards**, Director of Tax Policy Studies, Cato Institute

The following Members participated:

Democrats: Chair Mike Thompson (D-CA), Rep. Lloyd Doggett (D-TX), Rep. John Larson (D-CT), Rep. Linda Sánchez (D-CA), Rep. Suzan DelBene (D-WA), Rep. Gwen Moore (D-WI), Rep. Brendan Boyle (D-PA), Rep. Don Beyer (D-VA), Rep. Thomas Suozzi (D-NY), Rep. Stacey Plaskett (D-VI), Rep. Terri Sewell (D-AL), and Rep. Bill Pascrell (D-NJ)

Republicans: Ranking Member Adrian Smith (R-NE), Rep. Tom Rice (R-SC), Rep. David Schweikert (R-AZ), Rep. Darin LaHood (R-IL), Rep. Jodey Arrington (R-TX), Rep. A. Ferguson (R-GA), Rep. Kevin Hern (R-OK), and Rep. Ron Estes (R-KS)

II. Opening Statements

Chair Thompson (D-CA) attacked the current tax system for providing tax advantages that favor the wealthy and lead to wasteful tax avoidance. Specifically, he stated the wealthy evade taxes through failing to properly report income and overstating deductible expenses. He added that while outside the scope of this hearing, the Subcommittee will more closely examine IRS enforcement in conjunction with the Subcommittee on Oversight. He concluded that a fair system should appropriately tax the wealthy while preserving the important parts of our communities, such as small businesses and farm owners.

Ranking Member Smith (R-NE) defended the current tax regime established by the *Tax Cuts and Jobs Act* and argued that it is fair and successful in incentivizing constructive economic activity. He suggested that President Biden’s tax proposals, such as doubling the capital gains tax and repealing Section 1031 like-kind exchanges for real estate, would cause economic harm.

III. Witness Statements

Mr. Looney outlined the tax system’s advantageous treatment of inherited wealth, corporate and non-corporate business income, and capital gains as contributing factors to the increasing concentration of wealth and income inequality in the country. He stated these policies have reduced tax revenue and diluted the effectiveness of the tax system.

Mr. Oh advocated for tax reform policies that will increase the tax burden on the wealthy. Specifically, he suggested repealing stepped-up basis, shifting to a mark-to-market regime for more assets, and increasing the capital gains rate. He also suggested pursuing these reforms together as one package.

Mr. Gutman advocated for repeal of stepped-up basis and instituting a regime in which death and lifetime transfers are tax realization events.

Ms. Huang stated that preferential tax breaks for the wealthy have resulted in tax avoidance, sheltering, and evasion. Particularly, she noted that many wealthy tax filers try to push their “labor” income as “capital” income given its preferential treatment. She also noted that carried interest and pass-throughs are used by the wealthy to avoid paying top income and payroll rates.

Mr. Edwards criticized President Biden’s tax proposals in the *American Families Plan*. He specifically suggested that raising capital gains rates would generate little revenue while undermining private sector investment.

IV. Discussion

a. Repealing Stepped-Up Basis

Chair Thompson (D-CA) discussed exemptions from the proposed repeal of stepped-up basis for family owned businesses and farms included – without detail – in the *American Families Plan*. He highlighted a previous proposal enacted by Congress that provided an exemption for individuals who inherited a family business or farm from paying an estate tax if they continued to operate the business. He emphasized that Congress must protect these family owned businesses and farms as it proceeds with making changes to current tax law. **Mr. Gutman** discussed alternative approached, focusing in particular on the possibility of instituting a “carryover basis” regime.

Ranking Member Smith (R-NE) highlighted that the exemptions from the repeal of stepped-up basis for family businesses and farms that Democrats are suggesting would decrease the revenue benefit of the proposal. **Mr. Edwards** recommended that a reasonable compromise is to repeal the estate tax, and instead impose a tax on a carryover basis when the assets are sold. He added that he believes taxing based on valuation – one of the other alternatives suggested by **Mr. Gutman** – is hugely complicated.

Reps. Arrington (R-TX) LaHood (R-IL) argued that the Administration’s proposal would essentially result in a double tax at death that will negatively affect small businesses. He reiterated that repealing stepped-up basis hinders the ability to transfer agricultural land to family-owned operations and creates massive administrative burdens on families. He also made clear his position that there is no policy advantage to forcing a family to sell off its assets in order to pay a tax bill. **Rep. Ferguson (R-GA)** agreed that it would be unfair to penalize families who grow a business and want to pass it down to their heirs.

Rep. Pascrell (D-NJ) criticized stepped-up basis as one of the biggest loopholes in the tax system. He discussed his bill, the STEP Act, which would eliminate stepped-up basis and impose a capital gains tax at death. He suggested that President Biden’s proposal in *the American Families Plan* is “on the right track” and similar to his bill. **Rep. Pascrell** highlighted the one million dollar exemption for net capital gains included in his bill, and questioned whether this exemption is sufficient or if additional relief should be considered for farms and other family-owned businesses. **Mr. Gutman** suggested that a one million dollar gain exemption would eliminate the potential tax burden for many taxpayers.

b. Capital Gains Rates

Chair Thompson (D-CA) and Mr. Oh highlighted how preferential capital gains rates make it possible for wealthy individuals to pay a lower tax rate than middle class taxpayers, who are taxed on ordinary income at higher rates. **Reps. Pascrell (D-NJ) and Sánchez (D-CA)** criticized the tax system for allowing this disparate treatment and suggested that these policies hinder the ability of communities to invest in infrastructure and education.

Rep. Larson (D-CT) suggested that if preferential treatment of capital gains is allowed, it should come with requirements to distribute stock to employees. **Mr. Oh** and **Mr. Edwards** both agreed this would present a diversification issue for employee investments.

Rep. Rice (R-SC) defended preferential capital gains rates as a means to encourage investment, which he suggested results in innovation and productivity. **Mr. Edwards** agreed that capital gains are crucial to startup business and innovation.

c. Mark-to-Market System

Rep. Moore (D-WI) asked **Mr. Gutman** to explain whether transitioning to a mark-to-market system would be an inflationary expense and affect realization. **Mr. Gutman** explained that a mark-to-market regime eliminates a realization requirement to recognize gains and losses on assets and referenced **Senate Finance Committee Chairman Ron Wyden's (D-OR)** proposal. In discussing this approach, Mr. Gutman suggested that a mark-to-market system can be particularly problematic when considering non-marketable assets, such as closely-held businesses and farms.

Rep. Plaskett (D-VI) questioned the durability of a mark-to-market system during times of recession when asset prices fall. **Mr. Oh** emphasized this concern is why it is important to design a rule that does not allow for unlimited deductibility. He also suggested that if individuals are self-reporting, there might be an incentive to understate the value of their assets and thus suggested using a mark-to-market system only for publicly traded assets.

d. 199A Deduction

Rep. Sánchez (D-CA) criticized the *Tax Cuts and Jobs Act* for providing what she views as a means for wealthy Americans to hide their income in pass-through structures using the 199A deduction. She stated that despite being touted as a boost for small business, the Joint Committee on Taxation estimates that more than half the benefits of this deduction have gone to taxpayers who make over a million dollars.

e. IRS Enforcement

In response to a question from **Chair Thompson (D-CA)**, **Ms. Huang** discussed the differences in IRS enforcement when auditing wealthy individuals as compared to low-income individuals. **Ms. Huang** emphasized that the complex financial arrangements entered into by high-income earners require extensive expertise and resources to audit. **Rep. DelBene (D-WA)** highlighted the impact decreased IRS funding has had on audit rates, suggesting that a loss of IRS personnel has resulted in a dramatic drop in audits of high-income filers. Responding to an inquiry from **Rep. Sanchez** regarding whether increased audit rates of wealthier taxpayers would generate increased revenue, **Ms. Huang** confirmed that such an approach would raise additional tax revenue.

f. Wealth Tax

Rep. Estes (R-KS) urged Congress to focus on continued economic recovery, not punishing Americans with a wealth tax. **Mr. Edwards** agreed, noting that many European countries have repealed their wealth taxes because the administrative burdens were too high.

Rep. Suozzi (D-NY) highlighted the extraordinary amount the wealth of billionaires has grown since the 1990s and argued they should be sharing more of their wealth. **Mr. Edwards** countered this proposition by stating that their wealth is already being shared through creating jobs and lowering prices for American consumers.

g. State and Local Tax (SALT) Deduction Cap

Rep. Hern (R-OK) advocated against the Democrats' push to repeal the State and Local Tax (SALT) deduction cap, noting that 46 of the top 50 Congressional Districts that will benefit from the elimination of the SALT cap are represented by Democrats. On the other hand, **Rep. Pascrell (D-NJ)** emphasized that more people would be impacted by a repeal of the SALT cap than would be by a repeal of the stepped-up basis rule.