TCJA, Pillar Two, Inflation Reduction Act dominate discussion at Ways and Means hearing on White House budget plan

Republicans and Democrats on the House Ways and Means Committee stuck to their entrenched partisan positions as they sparred over the future of a host of temporary provisions in the Tax Cuts and Jobs Act of 2017 that are scheduled to expire at the end of 2025, the path forward for the global tax pact being advanced through the OECD, and the economic impact of the Inflation Reduction Act of 2022 during an April 30 hearing to discuss the Biden administration's fiscal year 2025 budget proposals with Treasury Secretary Janet Yellen.

TCJA: Middle-class taxes and Biden's $400,000 bright line

Ways and Means Committee Chairman Jason Smith, R-Mo., and most other Republicans on the panel pressed Secretary Yellen—the sole witness at the hearing—about a recent social media post by President Biden in which he stated that the Tax Cuts and Jobs Act (TCJA, P.L. 115-97), the Trump administration's legacy tax package that cleared the House and Senate and was signed into law in 2017 without any Democratic support, "is going to expire" and will "stay expired" if he is re-elected.
URL: https://twitter.com/JoeBiden/status/1782904787966558608
URL: https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf

Call and response: The committee's Republicans cast the president's statement as evidence that he intends to let the law's temporary tax relief provisions on the individual side of the code—such as reduced income tax rates, the expanded standard deduction, the increased child tax credit, and the 20 percent deduction for certain passthrough business income—sunset in their entirety after 2025, which would result in a significant tax hike for taxpayers across the income spectrum and would seem to violate the president's pledge not to increase taxes on households with income of less than $400,000 (although some might argue that since these changes were scheduled to take effect when the original law was passed in 2017, allowing them to expire as enacted is not itself a tax increase).

As GOP taxwriters repeated variations on this argument over the course of the four-hour hearing, Yellen consistently responded with variations on the mantra that President Biden has stated his principles for addressing the expiring TCJA tax provisions and intends to work with Congress to ensure that less affluent taxpayers will be held harmless from tax increases after those provisions lapse.

In what was perhaps her most expansive version of that answer, Yellen explained to Rep. Michelle Fischbach, R-Minn., that "[t]here will be a negotiation" between the president and Congress over what to do when the TCJA temporary tax cuts expire, and in that negotiation, he "will oppose any tax increases on families making less than $400,000, [while] at the same time, he will oppose keeping in place benefits that went to the wealthy."

Yellen also clarified in an exchange with Rep. Brian Fitzpatrick, R-Pa., that Biden will "work with Congress to determine how to offset the cost of tax relief for low- and middle-income taxpayers."

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Some uncertainty over 199A: As part of that back-and-forth between the panel's Republicans and the Treasury secretary, Florida GOP taxwriter Vern Buchanan asked Yellen whether the administration proposes to increase taxes on owners of passthrough businesses.

Yellen replied that President Biden "is committed to ensuring that no families—including those with passthrough businesses—will see their taxes increase if they make less than $400,000," adding that "as a matter of fairness," the wealthiest individuals and large corporations would see their taxes go up.

Yellen was less definitive, however, when Buchanan asked specifically whether the president would support full repeal of the section 199A deduction for passthrough business income (with no carve-out for middle-class taxpayers) if he is elected to a second term.

"I need to get back to you on that," she said.

Buchanan called the issue "critically important," noting that the under the TCJA, "[w]e went from corporate rates [of] 35 percent to 21 percent, but you can't have passthrough rates at 40 percent"—a reference to the pre-TCJA top individual rate of 39.6 percent that congressional Democrats and President Biden would like to see reinstated.

"It makes no sense . . . ," Buchanan said.

Corporate rate increase = Middle-class tax hike?: The TCJA's 21 percent corporate tax rate was enacted on a permanent basis and thus will not directly be on the menu of expiring provisions that the next Congress and presidential administration will have to address in 2025. President Biden's fiscal year 2025 budget blueprint, however, proposes to increase the corporate rate to 28 percent—a move that Republican taxwriters Kevin Hern of Oklahoma and Blake Moore of Utah contended would be a *de facto* middle-class tax increase since corporations would pass at least some of that cost on to consumers in the form of higher prices. Moore also alluded to statistics from the nonpartisan Joint Committee on Taxation (JCT) staff that he said show that the economic impact of hiking the corporate rate to 28 percent would be borne primarily by households with income of less than $500,000.

Yellen rejected that contention, commenting in an exchange with Moore that the economic analyses she has seen show "that the TCJA . . . was a regressive tax cut that disproportionately benefited the wealthy and large corporations, and the corporate tax cut enriched corporate shareholders at the expense . . . of middle-class families." Moreover, she said, the TCJA "promised an investment boom that never materialized."

Democrats decry TCJA's deficit impact: The panel's Democratic members, meanwhile, agreed with Yellen that the TCJA primarily benefits large corporations and upper-income individuals and they faulted Republicans—who controlled the House, Senate, and the White House in 2017—for passing a largely unpaid-for tax bill.

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Democratic taxwriter Lloyd Doggett of Texas argued that the GOP's current push to extend the Trump-era tax cuts would drive up the federal debt by some $3.5 trillion, according to the nonpartisan Congressional Budget Office.

Rep. Mike Thompson, D-Calif., noted that the lack of pay-fors in the TCJA—the legislation as enacted was estimated to reduce federal receipts by $1.5 trillion over 10 years—has had an inflationary effect on the economy. He asked Secretary Yellen to elaborate on "some responsible ways" that Congress could offset the cost of any TCJA extensions in 2025.

Yellen replied that the administration's latest budget proposal includes a number of revenue-raising provisions that would be appropriate. In addition to the proposed increase in the corporate tax rate to 28 percent—a level that she said would still represent a tax cut relative to pre-TCJA law—she noted that the president has called for increasing the excise tax on stock buybacks from the current 1 percent to 4 percent, increasing the corporate alternative minimum tax from 15 percent to 21 percent, imposing a new minimum tax on income and unrealized gains of taxpayers with wealth greater than $100 million, and enacting tax code changes that would align the US with the OECD's Pillar Two global corporate minimum tax agreement.

No consensus on OECD tax pact

That emerging OECD global tax pact likewise stoked partisan tensions among House taxwriters during the hearing. The agreement, which to date has been signed by nearly 140 countries, seeks to reallocate some of the taxing rights of countries based on where income is earned (Pillar One) and to ensure that certain large multinational corporations are paying a minimum tax rate of 15 percent globally (Pillar Two).

Republicans on the panel were particularly critical of Pillar Two, arguing that it is a revenue loser for the US and amounts to a surrender of US taxing authority to foreign competitors while Democrats, siding with Secretary Yellen, maintained that it is essential in ending a global "race to the bottom" on corporate taxation.

Revenue impact: Rep. Mike Kelly, R-Pa., cited an estimate from the JCT staff showing that Pillar Two could cost the US fisc $122 billion in lost revenue over the next decade if the rest of the world moves ahead with the agreement and the US stays on the sidelines, and that even if the US implements the global agreement in 2025, the domestic loss still could amount to $56.5 billion. (For prior coverage of the JCT release, see *Tax News & Views*, Vol 24, No, 25, June 23, 2023.)
URL: https://dhub.deloitte.com/Newsletters/Tax/2023/TNV/230623_1.html

Kelly asked Yellen to explain how the US would replace the lost revenue attributable to Pillar Two.

Yellen replied that the JCT's projected $122 billion revenue loss was calculated based on "an extreme negative" scenario. "In the most likely cases," she said, "the outcome in terms of tax collections would be positive, not negative."

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Treatment of nonrefundable tax credits: Chairman Smith and other Republican taxwriters also slammed Pillar Two for providing more favorable treatment for refundable tax credits, which are more common in jurisdictions outside the US, over nonrefundable credits—including the research credit—which are more prevalent in the US.

Secretary Yellen commented in an exchange with Smith that the US is engaged in negotiations with other countries participating in the tax pact to ensure favorable treatment for the R&D credit and that she was "hopeful these negotiations will be successful." She also noted that negotiators have already secured favorable tax treatment for the clean energy credits enacted in the Inflation Reduction Act of 2022 and for the low-income housing tax credit.

Dealing with bad actors: Rep. Michelle Steel, R-Calif., asked Yellen how negotiators of the OECD agreement can be sure whether China would sign on to Pillar Two and, if it did, whether it would play by the rules and impose the 15 percent minimum tax on its multinational enterprises.

Yellen explained that Pillar Two includes an enforcement mechanism—the undertaxed profits rule—that allows compliant countries to impose a top-up tax on multinational entities operating in their jurisdictions that are based in countries that are not imposing the minimum tax.

"If China imposes the tax, they can collect the revenue," Yellen said. If it doesn't, "we're going to collect the tax revenue and we're going to impose the tax on Chinese firms. This works to our advantage—not China's."

Oklahoma Republican Kevin Hern asked Yellen if Pillar Two would simply replace international competition over tax rates with "subsidy warfare" in which participating countries adopt the corporate global minimum rate but then enact new incentives to minimize its impact on their taxpayers.

Yellen replied that she was not aware of any "broad-based" effort to circumvent the minimum tax but noted that any such action would be a source of concern.

US implementation: Hern also told Yellen that Pillar Two will never be approved by a Republican-controlled Ways and Means Committee—an assertion that prompted Democratic taxwriter Suzan DelBene of Washington to ask the Treasury secretary to explain the implications for the US if it does not adopt the agreement.

Yellen replied that this is a global agreement, and that the US has "argued from the beginning that Pillar Two is good for the entire world." Other OECD nations, she said, "would see it as a failure on our part if we don't adopt it ourselves."

"It does undermine our ability to exhibit leadership with our allies," she added.

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Inflation Reduction Act tax credits

The notion of US tax policy potentially providing economic advantages to the nation's adversaries—notably, China—also fueled much of the GOP's criticism of the Inflation Reduction Act of 2022 (P.L. 117-169), President Biden's marquee tax legislation which moved through Congress with only Democratic support and includes a host of tax credits for domestic manufacturing and clean energy production that many Republicans in Congress would like to pare back or eliminate.
URL: https://www.taxnotes.com/research/federal/legislative-documents/public-laws-and-legislative-history/inflation-reduction-act-of-2022-%28p.l.-117-169%29/7dybc

Republicans poke holes in 'foreign entities of concern' rules: Chairman Smith, for example, contended that Treasury Department regulations implementing the Inflation Reduction Act's $7,500 tax credit for clean vehicles created "loopholes" related to the sourcing of battery components that will allow those credits to flow to companies with ties to foreign entities of concern, including China. Moreover, he said, the Treasury Department's standards for what constitutes a foreign entity of concern under the clean vehicle credit rules are more "China-favorable" than standards adopted by the US Commerce Department for credits related to production of semiconductors under the Chips and Science Act of 2022 (P.L. 117-167).
URL: https://www.congress.gov/117/plaws/publ167/PLAW-117publ167.pdf

Yellen countered that the Treasury and Commerce Department standards are "similar" and said that the clean vehicle rules include "very strong restrictions" that are phasing in this year and next year, which will preclude companies from receiving the credit if certain component parts are sourced in foreign entities of concern. (For its part, the IRS on May 3 announced the release of final regulations that, among other things, provide rules regarding the critical mineral and battery components requirements for the new clean vehicle credit—including standards for qualified manufacturers of new clean vehicles to determine if the battery components and applicable critical minerals contained in a vehicle battery are foreign entity of concern-compliant.)
URL: https://www.irs.gov/newsroom/irs-releases-final-guidance-for-certain-clean-vehicle-credits-under-the-inflation-reduction-act
URL: https://www.federalregister.gov/public-inspection/2024-09094/clean-vehicle-credits-transfer-of-credits-critical-minerals-and-battery-components-and-foreign

Smith replied that the Treasury Department "must push back against foreign adversaries" and noted that his panel recently marked up two bills intended to tighten eligibility requirements for the clean vehicle credit to close what he contends are gaps in current law. (The End Chinese Dominance of Electric Vehicles in America Act and the Stop Executive Overreach on Trade Agreements Act both cleared the committee along party lines on April 17. For additional details, see *Tax News & Views*, Vol. 25, No. 16, Apr. 19, 2024.)
URL: https://gop-waysandmeans.house.gov/wp-content/uploads/2024/04/H.R.-7980-Bill-Text.pdf
URL: https://gop-waysandmeans.house.gov/wp-content/uploads/2024/04/H.R.-7983-bill-text.pdf
URL: https://dhub.deloitte.com/Newsletters/Tax/2024/TNV/240419_4.html

In a subsequent exchange with Republican taxwriter Carol Miller of West Virginia, who sponsored the End Chinese Dominance on Electric Vehicles in America Act, Yellen said that current restrictions on foreign entities

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of concern will “surely curtail and almost prevent entirely” participation of Chinese companies in producing credit-eligible clean vehicle battery components.

When Miller asked if Treasury is aware that China is taking advantage of various US tax credits to “deepen its influence on domestic manufacturing industries,” Yellen replied that the department is doing all it can as it implements the Inflation Reduction Act to “strengthen” US supply chains and make them “less vulnerable” to China.

Democrats tout economic benefits: Throughout the hearing, Secretary Yellen and Democratic taxwriters maintained that the Inflation Reduction Act has been a boon to the US economy, citing increased domestic investment stemming from the legislation’s various clean energy tax incentives.

In an exchange with California Democrat Mike Thompson, Yellen stated that the Inflation Reduction Act is “catalyzing investments in clean energy technologies, strengthening supply chains, and creating new jobs.” She added that the prevailing wage and apprenticeship requirements to unlock certain bonus tax credits that are available under the legislation are helping to “ensure that the jobs that are being created are good jobs.”

Yellen also told Thompson and Ways and Means Committee Democrat Danny Davis of Illinois that these clean energy investments are in many cases being made in areas of the US that have not seen a high level of economic activity in recent years—including low-income urban and rural communities as well as communities whose economies had relied on now-shuttered coal mines and fossil fuel plants.

IRS mandatory funding stream

Yellen and the panel’s Democrats also touted the increased revenue collections resulting from new IRS enforcement programs and technology enhancements that were made possible with Inflation Reduction Act funding.

As enacted, the Inflation Reduction Act provided for an $80 billion mandatory funding infusion for the IRS—through 2032—to enhance its compliance programs, modernize its information technology systems, and overhaul its taxpayer services operations. Some $20 billion of that amount has since been clawed back as part of recent government funding deals that President Biden reached in 2023 with then-House Speaker Kevin McCarthy, R-Calif., and in 2024 with current Speaker Mike Johnson, R-La. The White House budget blueprint proposes to backfill that reduction by making the mandatory funding stream available through 2034—that is, for the additional years covered by the 10-year budget window in the fiscal year 2025 blueprint. In total, the budget proposes that the agency receive $104.3 billion in mandatory funding through 2034.

Mike Thompson and New Jersey Democratic taxwriter Bill Pascrell of New Jersey asked Yellen about how the IRS plans to deploy the mandatory funding stream it received under the Inflation Reduction Act to crack down on tax-avoidance activities by large corporations, complex partnerships, and wealthy individuals.

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Responding to a question from Pascrell, Yellen said the IRS is already using its new funding to hire specialized auditors, lawyers, accountants, and data scientists to unwind complex returns filed by the most sophisticated, high-dollar taxpayers that deliberately are underpaying their taxes—or in some cases, not paying them at all. She noted that one recent enforcement initiative focusing on noncompliance among taxpayers with income greater than $1 million has captured some $500 million in what had been forgone revenue.

On the technology front, Yellen note in an exchange with Democrat Suzan DelBene of Washington that the funds are enabling the IRS to launch initiatives using artificial intelligence to help its enforcement team sift through returns of high-wealth individuals and complex partnerships and identify likely candidates for audits.

As she discussed the agency's expanded compliance initiatives and compliance-related technological enhancements, Yellen also pointed out to the panel that audit rates among taxpayers with income of less than $400,000 have remained unchanged relative to historic levels, in line with a provision in the Inflation Reduction Act that forbids the IRS from using the new funds to increase audit rates among this segment of the tax base.

IRS promises heightened audit focus on corporate, high-wealth taxpayers: In a related development, the IRS on May 2 released an update and a supplement to its Inflation Reduction Act strategic operating plan in which it highlights how it has deployed the new funding since the legislation was enacted in 2022 and lays out the agency's future plans to enhance its enforcement and compliance activities, modernize its foundational technology, and improve the tools available to aid IRS employees in assisting taxpayers.
URL: https://www.irs.gov/pub/irs-pdf/p3744b.pdf
URL: https://www.irs.gov/pub/irs-pdf/p3744a.pdf

Notable highlights on the compliance side indicate that the IRS intends to use the mandatory funding stream to:

- Nearly triple audit rates on large corporations with assets over $250 million to 22.6 percent in tax year 2026, up from 8.8 percent in tax year 2019;
- Increase audit rates by nearly ten-fold on large, complex partnerships with assets over $10 million, jumping from 0.1 percent in 2019 to 1 percent in tax year 2026; and
- Increase audit rates by more than 50 percent on wealthy individual taxpayers with total positive income over $10 million, climbing from an 11 percent coverage rate in 2019 to 16.5 percent in tax year 2026.

Audit rates for small businesses and taxpayers with income of less than $400,000 will remain unchanged relative to historic levels, the IRS confirmed.

Echoing Secretary Yellen's comments to Ways and Means Committee members, the updated plan confirms that the increased audit scrutiny will be powered by ongoing efforts at the IRS to hire and train specialized compliance personnel and modernize its information technology.

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On the customer service side, the IRS indicated that it plans to, among other things, enhance its in-person and on-line services, accelerate digitalization of nontax forms, and simplify standard notices, all in an effort to make it easier for taxpayers to interact with the agency.

In a news release accompanying the updated strategic plan, IRS Commissioner Daniel Werfel noted that recissions to the mandatory spending amounts that were enacted this year have created "funding cliffs" for the agency. If the IRS is to maintain its efforts to ensure equal treatment of taxpayers across the income spectrum and transform its customer service culture, he said, Congress needs to approve the extended mandatory funding proposed in the administration's budget blueprint.

"This funding will ensure the IRS can continue its transformation efforts that we have outlined in the updated Strategic Operating Plan," Werfel said. "We need to continue working to make more improvements in taxpayer service, modernize technology, and ensure those with complex returns, including certain high-income individuals, large corporations, and complex partnerships, pay the taxes they owe."

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