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What a Difference Thirty Years Make: A Comparison of the Tax Reforms of 1986, 2014 and 2017

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WHAT A DIFFERENCE THIRTY YEARS MAKE:

A COMPARISON OF THE TAX REFORMS OF 1986, 2014 and 2017

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ABSTRACT

This paper compares the Tax Cuts and Jobs Act of 2017, as passed by the House (TRA17H) and under consideration by the Senate (TRA17S) with two major previous efforts at comprehensive tax reform: The Tax Reform Act of 1986 (TRA86) and the draft tax reform proposed by former Ways and Means Chair David Camp (R-MI) (TRA14). It shows that TRA14 was quite similar to TRA86, but that TRA17 is very different than both. Congress should abandon TRA17 and go back to considering TRA14 on a bipartisan basis.

1. Introduction

TRA17, as passed by the House (TRA17H, H.R. 1, the Tax Cuts and Jobs Act, November 16, 2017) and under consideration by the Senate (TRA17S, as passed by the Finance Committee, November 16, 2017) represents a major departure from the two major legislative tax reform efforts of the last thirty years –TRA86 and TRA14. **Most importantly, TRA86 and TRA14 were both revenue and distributionally neutral, while TRA17 adds at least $1.5 trillion to the deficit and is heavily skewed towards the rich.** The following compares the three tax reform efforts in detail and concludes that TRA14 was a much superior product than TRA17.

2. Individual Tax Reform

TRA86 cut the individual tax rate on ordinary income from 50% to 28% and raised the capital gains rate from 20% to 28%. This resulted in revenue losses on the individual side that were made up by raising the effective corporate tax rate. The estate tax rate was 55%, and the AMT was retained and expanded.

TRA14 had a top rate on ordinary income of 35% (on an expanded tax base that eliminated most tax expenditures such as employer provided health insurance and pension contributions). The capital gains and dividends rate was 24.8% (including the 3.8% ACA tax on investment income). The estate tax rate was 35% and the AMT was repealed, as was the carried interest provision.

TRA17H has a top individual rate on ordinary income of 39.6%, with a phase out of the lower brackets resulting in a top rate of 45.6%. TRA17S has a top individual rate on ordinary income of 38.5%. The capital gains and dividends rate remains 23.8%, and carried interest is maintained in both. The estate tax is repealed in TRA17H, while TRA17S doubles the exemption amount to $22 million. The AMT is repealed in both TRA17H and TRA17S.

Overall, TRA86 and TRA14 were distributionally neutral. TRA17 in both versions is heavily skewed in favor of the rich. TRA86 and TRA14 achieved revenue and distributional neutrality by expanding the base and limiting or eliminating deductions such as home mortgage interest and state and local taxes. TRA17 limits some deductions, but much less than TRA86 and TRA14. The disparate treatment of the estate tax and carried interest is typical. The estate tax, which only falls on the rich, was retained in TRA86 and TRA14 and repealed or severely limited in TRA17. The carried interest provision, which applies to super rich hedge fund managers, was eliminated in TRA86 (because there was no preferential rate for capital gains) and TRA14 and is retained in TRA17.

3. Corporate and Pass-Through Tax Reform

TRA86 cut the corporate tax rate from 46% to 34%, but significantly expanded the corporate base (e.g., by repealing the *General Utilities* rule that exempted appreciated assets from corporate tax), so that it raised revenue from the corporate sector to make up for revenue lost on the individual side. It made no changes in pass-through taxation of partnerships and S corporations other than providing that all publicly traded entities be taxed at the corporate level.

TRA14 cut the corporate tax rate from 35% to 25%. It made no changes in the taxation of pass-throughs, resulting in a ten percentage point differential between the top pass-through rate of 35% and the top corporate rate of 25% (but with an additional 24.8% on dividends and capital gains).

TRA17 in both versions cuts the corporate rate from 35% to 20%. Because the rate differential from the top individual rate is immense (as much as 25.6% in TRA17H), both TRA17H and TRA17S have special rules for pass-through taxation. TRA17H subjects passive pass-through income to a special rate of 25% while retaining the top individual rate of up to 45.6% on active pass-through income from services. TRA17S has a 17.4% deduction for non-service income of pass-throughs, resulting in an effective pass-through rate of 31.8%. Both TRA17H and TRA17S have complicated rules to try to distinguish pass-through income eligible for the lower rate from wages.

Unlike TRA86 and TRA14, TRA17 in both versions adopts expensing (current deduction for corporate acquisitions of machinery, etc.). Expensing results in a zero effective tax rate on the normal return on capital. To prevent negative tax rates, TRA17 puts limits on net interest deductions at 30% of EBITDA, but the remaining interest deduction plus expensing can still create negative tax rates (i.e., tax shelters).

Overall, these provisions of TRA17 are significant revenue losers (loss of $683.4 billion in TRA17S) and heavily skewed toward the rich, while TRA86 and TRA14 raised revenue from the corporate sector. The pass-through provisions of both TRA17H and TRA17S are uniquely prone to abuse, very complex, and reward rich individuals earning passive income through pass-throughs. TRA86 and TRA14 did not include special pass-through rules because the tax differential between the top individual and corporate rates was smaller (in TRA86 the top corporate rate was 6 percentage points **higher** than the top individual rate, and in TRA14 it was only 10 percentage points lower, in both cases without considering the extra layer of tax on dividends and capital gains).

4. International Tax Reform

TRA86 significantly strengthened the international tax provisions by adding more categories to Subpart F income and by imposing per category limits on the foreign tax credit. It retained deferral on active income with a tax on dividend repatriations.

TRA14 adopted territoriality (an exemption for dividends from active income) but with strong minimum tax provisions for foreign income not subject to foreign tax at 12.5% and limits on interest deductions related to exempt dividends.

TRA17 in both versions adopts territoriality. Both versions include minimum tax provisions that are significantly weaker than those of TRA14. In addition, both versions include inbound anti-base erosion and profit shifting (BEPS) provisions, and these most likely violate both our tax treaties and WTO rules while also being ineffective (because they only apply to transactions with related parties, thus causing many direct sales and services provided to unrelated parties to fall through the crack). TRA17S also has an export subsidy that is a blatant violation of WTO rules. Neither version of TRA17 has any anti-inversion rules despite creating additional incentives to invert to zero tax jurisdictions and thus avoid the minimum tax.

Overall, the international provisions of both TRA14 and TRA17 are weak. The lock-in problem that they are supposed to solve is much better addressed by abolishing deferral, since at a 20% rate with expensing US-based multinationals would have a competitive advantage over their rivals without deferral.

5. Conclusion: Back to the Drawing Board

In my opinion, both versions of TRA17 are fatally flawed because they (a) increase the deficit, (b) are skewed toward the rich, and (c) increase complexity while drawing new lines the IRS will find very hard to defend, like the line between wages and pass-through income. Congress should go back to the drawing board on a bipartisan basis, and TRA14 is a good starting point for such an effort.