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HOW TERRIBLE IS THE NEW TAX LAW?

REFLECTIONS ON TRA17

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1. Introduction

The academic commentary on the so-called “Tax Cuts and Jobs Act” (TRA17)¹, as signed into law on December 22, 2017, has tended from the negative to the super-negative. For example, Ed Kleinbard has written that:

The Tax Cuts and Jobs Act, this year’s Christmas present to the donor class, is an abomination. Its top-heavy distribution of cuts, its wasteful mistargeting of incentives, and its funding of permanent corporate tax cuts via tax hikes on millions of ordinary taxpayers have been widely publicized. From the other direction, whatever virtues the bill might have are completely swamped by its trillion-dollar plus impact on government deficits. But before moving on, we should review some of the process through which this bill was fashioned.²

How justified is this negative assessment? While there are problems with TRA17, many of them are overstated or can be fixed in future legislation. In my opinion, as explained below, the deficit and distributional problems have been exaggerated. The process issues Prof. Kleinbard bemoans in his editorial were real and led to some weird results (e.g., the last minute retention in the Senate of the corporate AMT at the same rate as the regular corporate tax, which had endless unintended consequences, but was eliminated in conference), but Republicans are correct to point out that most of the major reforms in the bill (e.g., territoriality) have been the topic of endless hearings, and that the process was not necessarily worse than some previous

¹ The final act omitted this clunky moniker for procedural reasons. I prefer TRA17 to TCJA both because I dislike politicized names and because I regard TRA17 as no less a tax reform measure than TRA86. In the international arena, TRA17 is a more significant tax reform than TRA86, and the change to taxation of pass-through income, although regrettable, is as important as any of the changes made to business taxation in TRA86.

² <http://thehill.com/opinion/finance/363096-senators-picked-americans-pockets-via-degraded-tax-process>. See also Alan Blinder, *Almost Everything Is Wrong With the New Tax Law*, *Wall Str. Journal* (Dec. 27, 2017).

efforts (even the sacred TRA86 had last minute compromises in conference, and was followed by a series of technical corrections acts to fix its problems).³

The following addresses the two main critiques of TRA17- its lack of revenue and distributional neutrality. It then analyzes some of the main provisions and suggests that many of these represent real and positive reform, not less than TRA86. Finally, I argue that there is one big problem in TRA17, the pass-through provisions, and that it should be possible to fix those in the future.

2. The Horrible Deficit

The first critique of TRA17 is that unlike TRA86 and the proposed TRA14 (the Camp draft), it is not revenue neutral. On a static basis (i.e., an estimate based on taxpayer behavioral response but not macroeconomic effects), TRA17 loses \$1.456 trillion over a decade. Even on a dynamic basis, according to the JCT, TRA17 loses almost \$1 trillion over a decade.

How horrible is this? THE US public debt is approaching \$20 trillion, and actuarial deficits of the main entitlement programs are about \$28 trillion. So in comparison, another \$150 billion per year is not a huge increase. The basic problem is the debt and the future actuarial deficit, not the increase due to TRA17, especially since current interest rates are very low.

In addition, it should be remembered that these are just estimates. The JCT is normally wrong in estimating revenue- in hindsight it is frequently off by huge amounts. Nobody, not even an economist with the latest models, can predict ten years into the future. Remember 2008.

But isn't it imprudent to add to the debt when it is already so high, and is likely to go much higher as the baby boomers retire? I think the real question is why savvy investors are willing to buy US 30 year Treasury bonds when they know that (according to the actuaries) by 2047 the entitlements (Social Security, Medicare and Medicaid) will consume all of the US government's revenue, leaving nothing for servicing their debt. Do they really expect the entitlements to be cut in order to pay interest and principal to foreign bondholders? Surely that is politically implausible (seniors vote in very high percentages).

There are three reasons investors are willing to buy US bonds under these circumstances. First, they know that the US federal government has never defaulted since 1787. Second, they know that the US borrows in its own currency, unlike Greece or Argentina. And third, they know that the US is an undertaxed country (31st out of 35 members of OECD). If necessary, the US can increase taxes and pay off \$20 trillion or more. I see a federal VAT in our future, and that will not be a bad thing, as almost every other country has discovered. A broad-based federal VAT at

³ Admittedly, it may be more difficult to enact any technical corrections to TRA17 given the current hyper-partisan nature of our politics, which is very different than the prevailing ethos in 1986-1988.

15% (the lower end of EU VATs) can raise \$1.5 trillion in a single year, wiping out the ten year TRA17 deficit increase.

3. The Horrendous Distribution

But what about the total lack of distributional neutrality, contrary to TRA86 and even TRA14? TRA86 was indeed distributionally neutral, but it achieved this by cutting taxes on individuals and raising them on corporations, and that seems counter-productive at present given that the US corporate tax rate was until TRA17 the highest in OECD. TRA14 was also distributionally as well as revenue neutral, but recall that then Ways and Means Chairman Camp (R-MI) could not even get a vote on it in his own committee.

The JCT distributional tables for the House version of TRA17 show that most taxpayers (61.7%) get a tax decrease and another 30.2% show no change, so that only 8.1% see their taxes increase. The Senate version of TRA17 is similar except that it shows more increases after 2025 as the individual tax cuts expire, but nobody seriously thinks this will actually happen for middle class taxpayers (the Bush tax cuts for the middle class were made permanent in the fiscal cliff of December 2012, when Democrats held all the cards).

It is true that the distribution is skewed toward the rich. But there are several countervailing considerations. First, given the declining marginal utility of money, a \$500 tax cut for a family earning \$50,000 to \$75,000 may be worth more than a \$5000 tax cut for millionaires. Second, the percentage of actual millionaires (income over \$1 million) getting a tax cut over \$500 is lower than the percentage of upper middle class taxpayers (income \$200,000-\$1 million) getting such a cut.

Third and most importantly, the distribution tables are skewed by three facts. First, if you take out the pass-through provisions, the cut to individuals is not so large (\$711.5 over a decade). Second, given that the top rates are practically unchanged (37% in lieu of 39.6%), most of these cuts go to the middle class.

So where does the distributional skew come from? It comes from two elements: First, the pass-through provisions, which costs \$414.5 billion, and which as discussed below are heavily skewed toward the top. Second, the corporate provisions, which cost \$653.8 billion, offset by revenue raised by the international provisions (\$324.4 billion).

The pass-through provisions are really problematic, as discussed below, and should ideally be repealed in the future on a bipartisan basis (when the votes of Sens. Johnson and Daines are less important). As for the corporate provisions, the problem is that nobody knows what the incidence of the corporate tax is, and the JCT's assumptions may or may not be correct. I would guess that the incidence shifts depending on economic circumstances, and given that the current unemployment rate is quite low, it is plausible that labor will reap at least some of the

benefits of the corporate tax cuts in the form of higher wages (although this could lead to inflation and higher interest rates and a recession that cancels out those higher wages). Overall, if one eliminates the effect of the pass through and corporate provisions, the distributional effects of TRA17 look much better, even if one also takes the estate tax into account (as the JCT does not).

4. The Devil in the Details

When one examines the details, other than the pass-through provisions, TRA17 does not look terrible, and not even much worse than TRA86. A lot of it is taken from TRA14, which was widely praised.

On the individual provisions, the main change (other than the rate changes, which happen with some frequency and are likely to be reversed in the future) is to replace the personal exemption and most of the itemized deductions with a larger standard deduction plus an expanded child credit. Overall these provisions largely offset each other (the net revenue loss over a decade is only \$82.3 billion). For most taxpayers this will lead to major simplification, since over 90% of them will not have to worry about itemized deductions and if they only have wage income tax filing will really be simplified. For the top 10%, they will lose some cherished deductions (SALT other than \$10k in property or income tax, some home mortgage interest), but they can afford it.

On the corporate side, the main change is a long overdue reduction of the rate to 21%, plus limited expensing (which is not worth very much in today's interest rate environment, but could become important in the future, and only loses \$86.3 billion over a decade) and a partial repeal of interest deductibility (total repeal would have been better given that even 30% deductibility plus expensing and a participation exemption lead to negative tax rates and tax sheltering). The other corporate provisions are less important but they generally raise revenue and partially offset the rate reduction in ways that are reminiscent of TRA86 (which also cut the corporate tax rate from 46% to 34% but significantly expanded the base).

On the international provisions, there is a relatively high rate (15.5% and 8%) on past offshore cash and non-cash accumulations, which raises \$338.8 billion and is about as good as can be expected (the cash rate is higher than the one in Pres. Obama's proposal). The widely supported participation exemption costs money (\$223.6 billion) but is more than offset by a 10.5% minimum tax on future offshore accumulations above a "hurdle rate" tied to tangible assets (\$112.4 billion), plus a 10% minimum tax on base erosion payments to related parties (\$149.6 billion). Overall these provisions are similar to TRA14 and the Obama proposals, and their

problems can mostly be fixed by adjusting the rates upward (which a future Democratic Administration and Congress are likely to do).⁴

Overall, these changes do not strike me as unreasonable, and they definitely qualify as tax reform and not just tax cuts- on the international side these are the most significant changes since 1962.

5. One Big Problem

There is one big problem with TRA17: The pass through provisions. These cost a lot of money, are distributionally skewed to the top, and are horribly complex.

Moreover, the pass-through provisions are totally unnecessary. The tax reform effort has been driven by two key elements: The President's desire for a low corporate tax rate, and the determination not to significantly reduce the top marginal rate on ordinary income. Since owners of pass-throughs pay tax at the ordinary income rate, this has created the perception that the bill is unfair to pass-through owners.

But this perception is wrong, for three reasons. First, many pass through owners (e.g., hedge fund managers and investors) pay tax at the 23.8% rate on capital gains and dividends, not at the ordinary income rate. Second, taxable individual shareholders in C corporations are subject to a second level of tax on distributions and capital gains at 23.8%, so their after tax return under the proposed rate structure is $(100-21=79 - (23.8 \times 0.79) = 60.2)$, which is almost identical to the after tax return on a pass through investment even if there was no rate reduction at all for pass through income ($100-37=63$). Third, if owners of pass-throughs do not like to be taxed at 37% on pass through income, they just need to check the box and magically their pass through becomes a C corporation taxed at 21%.

The problem is that TRA17 tries to accommodate these spurious concerns by allowing a 20% deduction for some pass-through owners, resulting in an effective tax rate of 29.6%, which is much better than the C corporation combined rate (39.8%). Even that would not be too much of a problem except that it then leads to the desire to segregate income from services earned by pass-throughs (e.g. by lawyers, accountants and physicians) from income from capital, and this creates an unworkable, unadministrable mess.⁵

⁴ The problem with BEAT is that at 10% it allows deductions to offset over half the 21% corporate rate, but that can be addressed by raising the BEAT rate to 21%. The problem with GILTI is the difference between the 10.5% rate on some foreign income and the 21% rate on some domestic income, but that difference can be reduced by raising the GILTI rate. The problem with FDII is the 13.125% rate, which is significantly less than 21% and therefore a prohibited export subsidy, but that too can be made more WTO compatible by raising the FDII rate.

⁵ For the details of the mess this creates see David Miller, Tax Planning Under the Tax Cuts and Jobs Act: Flow-Throughs Are the Answer to Everything (available at www.ssrn.com, abstract 3070662), and Michael Schler, Reflections on the Pending Tax Cuts and Jobs Act (Tax Forum no. 686, Dec. 4, 2017). See also Avi-Yonah, Reuven S.

6. Conclusion

Overall, TRA17 is not much worse than TRA86 or TRA14. It increases the deficit, but not by an impossible amount; it is distributionally skewed, but less so than is usually assumed; and its details are not terrible (on the international side they are a big improvement over prior law). There is one big problem, the pass through provisions, and we can only hope that as its horrible implications unfold it will be a prime candidate for repeal.

and Batchelder, Lily L. and Fleming, J. Clifton and Gamage, David and Glogower, Ari D. and Hemel, Daniel Jacob and Kamin, David and Kane, Mitchell and Kysar, Rebecca M. and Miller, David S. and Shanske, Darien and Shaviro, Daniel and Viswanathan, Manoj, *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation* (December 7, 2017). Available at SSRN: <https://ssrn.com/abstract=3084187> or <http://dx.doi.org/10.2139/ssrn.3084187> and Avi-Yonah, Reuven S. and Batchelder, Lily L. and Fleming, J. Clifton and Gamage, David and Glogower, Ari D. and Hemel, Daniel Jacob and Kamin, David and Kane, Mitchell and Kysar, Rebecca M. and Miller, David S. and Shanske, Darien and Shaviro, Daniel and Viswanathan, Manoj, *The Games They Will Play: An Update on the Conference Committee Tax Bill* (December 18, 2017). Available at SSRN: <https://ssrn.com/abstract=3089423>.