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BACKGROUNDER

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Analysis of the "Unified Framework for Fixing Our Broken Tax Code"

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Abstract

The recently released Unified Framework for Fixing Our Broken Tax Code simplifies tax remittance, lowers taxes on individuals, and updates the business tax code so that American firms and the people they employ can be globally competitive again. The tax code is badly in need of reform and the Unified Framework is a solid foundation from which Congress can draft legislation. The Framework can be improved on many margins, including by lowering the capital gains and dividends tax rate and making full expensing permanent. The final details of almost every proposed change will be important determinants of tax reform's ultimate success in growing the economy and improving the status quo.

The House, Senate, and White House have released the broad outlines of a consensus tax plan that will guide congressional tax writers and the budget process in the coming months. The reforms outlined in the Unified Framework for Fixing Our Broken Tax Code work to simplify tax remittance, lower taxes on individuals, and update the business tax code so that American corporations and the people they employ can be globally competitive again.[1]

Tax reform that follows this most recent framework has the potential to unleash higher wages, create more jobs, and unveil untold opportunity through a larger and more dynamic economy. However, important decisions remain in the coming months that could undermine the pro-growth benefits of the current outline. Congress will be pressured to meet the demands of special interests, maintain the current level of taxes on high earners, raise additional

KEY POINTS

- The U.S. tax code is badly in need of reform. The Unified Framework is a solid foundation from which Congress can draft legislation that simplifies the tax code and lowers taxes on individuals and businesses.
- The Framework lowers the corporate tax rate to 20 percent, lowers the pass-through rate to 25 percent, proposes temporary expensing, and moves toward a territorial tax system.
- For individuals, the Framework lowers rates, consolidates income tax brackets, doubles the standard deduction, expands the child tax credit, and repeals the death tax.
- The Framework can be improved on many margins, including by lowering the capital gains and dividends tax rate and making full expensing permanent.
- The final details of this plan will be important determinants of tax reform's ultimate success in growing the economy and improving the status quo.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3255**

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revenue, and tax international profits. Each of these additional demands could erode the pro-growth nature of the current reform and must be resisted.

Business Tax Reform

The Framework outlines six significant changes to modernize and reform the tax treatment of businesses in the U.S. Taken together these reforms would be a significant stimulus to the U.S. economy by attracting international business investment and jobs to America. There are, however, margins on which the Framework can be improved for greater economic growth and additional simplicity.

Full Expensing. The most pro-growth component of tax reform is permanent, full, and immediate expensing of all business costs. This provision alone could allow the economy to grow 5 percent larger and create one million jobs over the next decade.[2] Expensing allows companies to deduct the cost of investments immediately, such as the cost of building a new factory needed to hire additional workers.[3] The Framework grants five years of expensing, but exempts structures from this simplification. In any final legislation, this provision should be made permanent and available to all investments.

Expensing should be easily expanded at little additional cost. A majority of expensing's cost is accumulated within the first few years of the policy change and steadily decreases thereafter.[4] Temporary expensing is also likely to increase the cost in the first few years as businesses shift investment up into the five-year window. Tax policy that distorts the timing of investments, such as temporary expensing, rather than changing the long-run level of business investment, creates a one-time increase in investment that is not sustained over time.[5]

Permanent expensing must be a primary component of any tax reform plan that emphasizes economic growth and job creation. As the Framework evolves, Congress should resist the temptation to increase revenue by denying expensing for certain types of investments or inventories. Each additional carve-out would cut into the potential jobs and economic growth this change can achieve.

20 Percent Corporate Rate. U.S. businesses face the highest statutory corporate tax rates in the developed world. Using other measures of corporate taxes tells the same story: The United States ranks consistently as one of the worst in business tax environments.[6] Over the past few decades countries around the world have steadily lowered their corporate tax rates, leaving American businesses behind.

The Framework takes a bold step to move the U.S. corporate tax rate into line with those around the world. The plan calls for a 20 percent corporate tax rate, down from the current federal rate of 35 percent. A 20 percent federal corporate tax rate is the upper bound for global tax competitiveness. Even after adoption of this recommendation, when average state taxes are added in, the U.S. would still have an average cumulative tax rate higher than the worldwide average of 23 percent.[7]

The corporate income tax is an inefficient and economically destructive mechanism for raising revenue. It is effectively a *second* layer of tax, compounding the current 23.8 percent capital gains and dividends rate paid by individuals when corporate investments are realized as income.[8] The new pro-

1. U.S. Treasury Department, "Unified Framework for Fixing Our Broken Tax Code," September 27, 2017, https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf (accessed October 2, 2017).
2. Tax Foundation, "Options for Reforming America's Tax Code," June 6, 2016, https://files.taxfoundation.org/20170130145208/TF_Options_for_Reforming_Americas_Tax_Code.pdf (accessed September 29, 2017).
3. Adam N. Michel and Salim Furth, "For Pro-Growth Tax Reform, Expensing Should Be the Focus," Heritage Foundation *Issue Brief* No. 4747, August 2, 2017, http://www.heritage.org/taxes/report/pro-growth-tax-reform-expensing-should-be-the-focus.
4. Kyle Pomerleau and Scott Greenberg, "Full Expensing Costs Less Than You'd Think," Tax Foundation, June 13, 2017, https://taxfoundation.org/full-expensing-costs-less-than-youd-think/ (accessed October 2, 2017).
5. Kyle Pomerleau, "Economic and Budgetary Impact of Temporary Expensing," Tax Foundation *Fiscal Fact* No. 561, October 4, 2017, https://taxfoundation.org/economic-budgetary-impact-temporary-expensing/ (accessed October 10, 2017).
6. Adam N. Michel, "The U.S. Tax System Unfairly Burdens U.S. Business," Heritage Foundation *Backgrounder* No. 3217, May 16, 2017, Chart 1, http://www.heritage.org/taxes/report/the-us-tax-system-unfairly-burdens-us-business.
7. Kari Jahnsen and Kyle Pomerleau, "Corporate Income Tax Rates around the World, 2017," Tax Foundation *Fiscal Fact* No. 559, September 7, 2017, https://taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/ (accessed September 29, 2017).
8. The statutory 20 percent top marginal capital gains and dividends rate, plus the 3.8 percent surtax on net investment income.

posed federal top marginal effective tax rate on traditional C-corporation capital investments can be as high as 39 percent on some dividends (which is down from 50.5 percent).[9] This assumes that the capital gains and dividends tax remains at current levels, a topic the Framework does not directly address.

Paired with full expensing, a 20 percent corporate tax rate would encourage significant new investment in the U.S., which would primarily benefit workers through higher wages and more jobs.[10]

25 Percent Pass-Through Rate. Under the current tax code, pass-through businesses that pay tax through the individual tax code are taxed at a top marginal federal tax rate of 43.4 percent, a combination of a top income-tax rate of 39.6 percent and an additional 3.8 percent Obamacare tax on net investment.

The Framework creates a new 25 percent maximum tax rate on pass-through business income. The new 25 percent rate for pass-through income is a full 10 points lower than the proposed 35 percent rate for wage income. The Framework calls for unspecified rules to combat re-characterization of personal income into business income in order to prevent tax avoidance.

The proposed lower rate for pass-through income presents two serious challenges for congressional tax writers.[11] First, anti-abuse rules to prevent income re-characterization between the 35 percent and 25 percent rates would either be arbitrary and unfair to certain types of businesses or subjective, easily gamed, and administratively complex. To mitigate this problem, Congress should work to keep the pass-through rate and top personal rate as similar and low as possible. Second, pass-through income does not face the second layer of capital gains and dividends taxes, thus a 25 percent pass-through rate would be tax-advantaged compared to the 39 percent top effective rate for some business investments, particularly when paid out as dividends.[12] Congress can mitigate these problems by lowering the capital gains and dividends tax rate and further lowering the top marginal wage-income-tax rate.

Territoriality. The Framework claims to include a territorial corporate system that only taxes corporate income earned in the U.S. by allowing a 100 percent exemption for dividends from foreign subsidiaries. However, the Framework also mentions a possible international minimum tax that would undermine the benefits of a true territorial system.

A territorial system would replace the current U.S. custom of taxing the worldwide profits of American corporations if they want to bring those overseas profits back to the U.S. The current worldwide system is outdated and has resulted in over $2.5 trillion in U.S. business profits being locked overseas.[13] A territorial system, on the other hand, would put U.S.-headquartered businesses on an equal footing with their foreign counterparts.

As part of the transition to the territorial system, the Framework taxes the approximately $2.5 trillion of accumulated overseas profits at an unspecified rate, taxing illiquid assets at a lower rate. Often referred to as "deemed repatriation," this one-time tax should be as low as possible, and the revenue should only be used to support pro-growth reforms such as permanent full expensing and lower corporate rates.

Congress must also resist the temptation to levy an international minimum tax. The Framework specifically mentions taxing the global foreign profits of U.S. multinational corporations at a reduced tax rate. Levying a new tax such as this would constitute a backdoor reimplementation of the worldwide tax system. If Congress is worried about profit-shifting they should further lower the corporate tax rate and

9. A corporation first pays the new maximum statutory tax rate of 20 percent on each $1 of profit, leaving $0.80 of retained profit to be either distributed as a dividend or realized as capital gain. Then applying the individual's 23.8 percent tax rate to the $0.80 leaves approximately $0.61 out of the original $1, resulting in a combined top marginal effective tax rate of about 39 percent on capital investments.

10. Adam N. Michel, "The High Price That American Workers Pay for Corporate Taxes," Heritage Foundation *Backgrounder* No. 3243, September 11, 2017, http://www.heritage.org/taxes/report/the-high-price-american-workers-pay-corporate-taxes.

11. Scott Greenberg, "Should the Corporate Rate and the Pass-Through Rate Be Identical?", Tax Foundation, July 13, 2017, https://taxfoundation.org/corporate-rate-pass-through-rate-parity/, (accessed October 2, 2017).

12. The 39 percent effective rate is only strictly true for qualified dividends. The capital gains tax rate may be lower in real terms depending on how long the stock is held, the interest rate, the inflation rate, and other variables.

13. Jeff Cox, "U.S. Companies Are Hoarding $2.5 Trillion in Cash Overseas," CNBC, September 20, 2016, https://www.cnbc.com/2016/09/20/us-companies-are-hoarding-2-and-a-half-trillion-dollars-in-cash-overseas.html, (accessed October 2, 2017).

strengthen income sourcing, expense allocation, and affiliated intercompany pricing rules—all of which can be used to shift profits outside the U.S.

Limited Interest Deduction. The Framework limits the current unlimited deduction for net interest expense for C-corporations but does not specify the limit. The current interest deduction keeps debt-financed investment from undergoing an additional layer of tax when it is collected and taxed as income by the lender. However, this creates a bias in favor of debt financing and against equity financing, which does face two layers of tax. Interest should be completely disregarded from the tax system, taxable to the lender and deductible to the borrower, or the opposite, taxable to the borrower and deductible to the lender.[14] Disregarding interest and other financial transactions both dramatically simplifies the tax system and raises revenue that can be used to reduce tax rates.

The current treatment of interest in the tax code is neither uniform nor ideal. Many forms of interest expenses are not deductible to the individual and can often escape taxation when distributed to international or other tax-preferred entities. Ideally, the Framework would choose one fully consistent treatment of interest and implement it across the tax code.

Short of fixing the whole system, a partial limit on the net interest deduction is an acceptable compromise to bring partial parity between debt and equity financing, could help as an anti-base erosion tool in international taxation, and would raise revenue for other pro-growth reforms. Limiting the interest deduction should only be undertaken if paired with permanent full expensing and lower corporate tax rates.[15]

Special Interest Subsidies. The Framework explicitly eliminates the Section 199 production-activities deduction for domestic manufacturers, and "repeals or restricts" most other special exclusions and deductions.[16] Eliminating business tax subsidies will be politically difficult, but the Framework should be commended if it indeed is able to rid the tax code of these provisions, using the savings generated to lower tax rates for all businesses.

To strengthen the Framework further, Congress should repeal every special interest subsidy in the tax code.[17] The Framework explicitly protects both the research-and-development and low-income housing tax credits. Although politically popular, these credits are no different than any other subsidy the government uses to pick winners and losers in the market.[18] Every business tax subsidy should be eliminated.

Individual Reform

The Framework outlines additional reforms for individual taxpayers to lower rates and simplify tax remittance. Many yet-to-be-determined details of each reform—and their interactions—are crucial to how the current Framework would impact specific taxpayers. Although middle-class tax cuts are an important part of updating the tax code, Congress's focus should remain on simplification, eliminating unfair and economically harmful tax privileges, lowering marginal tax rates, and implementing the most pro-growth business tax reforms.

Lowers Individual Tax Rates. The Framework lowers rates and consolidates tax brackets for individuals. The three new income-tax brackets (down from seven) are 12 percent, 25 percent, and 35 percent. The top marginal rate is lowered from 39.6 percent. The plan mentions an additional fourth top rate may be added to ensure distributional neutrality.

The Framework does not include income brackets for the new tax rates, so little can definitively be said about how total tax liabilities would change,

14. Curtis Dubay, "An Alternative Way to Treat Interest Properly in Tax Reform," Heritage Foundation *Issue Brief* No. 4465, September 30, 2015, http://www.heritage.org/taxes/report/alternative-way-treat-interest-properly-tax-reform.
15. Alan Cole, "Interest Deductibility—Issues and Reforms," Tax Foundation *Fiscal Fact* No. 548, May 4, 2017, https://taxfoundation.org/interest-deductibility/ (accessed September 29, 2017).
16. Internal Revenue Code, § 199 (2017).
17. Special interest tax subsidies are different from "tax expenditures" as defined by the Joint Committee on Taxation or the Office of Management and Budget. Tax subsidies do not include those items that correct for double taxation, such as the lower rate on capital gains and dividends or accelerated depreciation.
18. Chris Edwards and Vanessa Brown Calder, "Kill the Loopholes, Including the One for 'Low-Income Housing,'" *The Wall Street Journal*, September 18, 2017, https://www.wsj.com/articles/kill-the-loopholes-including-the-one-for-low-income-housing-1505774844 (accessed September 29, 2017), and Jason J. Fichtner and Adam N. Michel, "Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?" Mercatus Center, July 14, 2015, https://www.mercatus.org/publication/can-research-and-development-tax-credit-be-properly-designed-economic-efficiency (accessed September 29, 2017).

especially when changes to deductions and credits are considered.

Consolidating the brackets and lowering the top marginal rate would provide simplification of the system and should provide lower tax liabilities for most taxpayers. However, adding a fourth higher bracket would significantly undermine the benefits of the proposed reforms by decreasing incentives to work, save, and invest.

Increases the Standard Deduction. The Framework almost doubles the standard deduction, consolidating the additional standard deduction and personal exemptions into the one larger deduction. For married joint filers the deduction would be $24,000 and for single filers, $12,000. The expanded deduction effectively increases a zero percent tax bracket, probably fully encompassing the current bracket now paying the 10 percent income-tax rate.

The proposed system of deduction and exemption consolidation and expansion is a simplification of the current code that should be both fairer and easier to administer, but could have the unintended consequence of leaving a smaller number of people footing the income-tax bill. Depending on the design, this increase would likely exempt more people from paying any income tax at all. Fewer people paying income taxes would have the unfortunate side effect of the government appearing to cost less for those taxpayers. Decreasing the number of income-tax paying households would lower the cost of future government expansions for those taxpayers who do not pay income tax, which could lead to higher overall taxes in the future.

Expands the Child Tax Credit. The Framework repeals the personal exemption for dependents, "significantly increases" the Child Tax Credit (CTC), and increases the income limits at which the credit currently begins to phase out. A new non-refundable credit of $500 for non-child dependent care is also included.

Taken together, it is uncertain how these changes would ultimately alter the current tax preference for having children. To replace the full value of the dependent exemption for a taxpayer in the 25 percent bracket, assuming no other changes in the current tax system, the CTC would need to be doubled, an increase of about $1,000. Paired with the new, larger standard deduction and a lower tax rate, most families could see a lower tax liability with no increase or a much smaller increase in the CTC.

Tax reform that prioritizes economic growth should limit any increases in the CTC and standard deduction that are not strictly making up for changes elsewhere in the tax code. These sorts of incentives have little impact on economic growth and the lost revenue would be better used for lowering marginal tax rates.

Changes Itemized and Other Deductions. The Framework claims to eliminate most itemized deductions—without detailing the specifics. The home mortgage interest and charitable contributions deductions are explicitly retained. The Framework also uses general language about retaining tax benefits that "encourage work, higher education and retirement security."[19]

Although not explicitly mentioned, it is important for Congress to eliminate the state and local tax deductions. Allowing taxpayers to write off the cost of state and local income, sales, and property taxes, and exclude municipal bond interest, benefits only a minority of taxpayers and creates a federal subsidy for the expansion of government at the state level. This forces people in low-tax states to subsidize big-government in states like California, Illinois, and New York. The elimination of these deductions could allow federal tax rates to decline by as much as 16.4 percent and an average of 7.3 percent.[20] The state and local tax deductions are bad policy and unfair: Congress must eliminate them as part of tax reform.

As the Framework develops further, Congress should include reforms to those programs that are intended to encourage work, such as the Earned Income Tax Credit, but not expand them. The rules and eligibility requirements for retirement savings should be simplified, contribution thresholds should be expanded, and restrictions on disbursements should be reduced or eliminated. Congress should eliminate federal tax credits for higher education because they increase complexity, distort incentives, and drive up cost.

19. U.S. Treasury Department, "Unified Framework," p. 5.

20. Rachel Greszler, Kevin D. Dayaratna, and Michael Sargent, "Why Pro-Growth Federal Tax Reform Should Eliminate State and Local Tax Deductions," Heritage *Backgrounder* No. 3256, October 16, 2017, http://www.heritage.org/taxes/report/why-tax-reform-should-eliminate-state-and-local-tax-deductions.

Repeals the Death Tax. The Framework repeals the estate tax and generation-skipping transfer tax. These death taxes are an unnecessary burden on businesses and families who often cut back on benefits, investments, and employees in response to end-of-life taxes. The death tax keeps new jobs from being created, hurting not just the affected businesses, but the economy as a whole. Because it is a tax on capital, the death tax destroys thousands of jobs and slows economic growth. However, the death tax is not misguided only because it hurts the economy: The death tax should be repealed because a citizen's death should not be a revenue opportunity for Washington.

Repeals the Alternative Minimum Taxes. The Framework eliminates the alternative minimum tax (AMT) in both the corporate and individual tax codes. The AMT generally applies an alternative tax rate to a more broadly defined measure of income and allows a narrower set of deductions with the intention of increasing the tax liability for those firms and individuals who can uniquely lower their effective tax rate by taking advantage of the normal tax system. The problem is that the AMT does its intended job poorly and inefficiently by burdening taxpayers with additional paperwork.

Tax reform that fixes the primary tax system will make the AMT an even more unnecessary and burdensome appendage. Repealing the AMT is an important part of tax reform.

Conclusion

The U.S. tax code is badly in need of reform and the Unified Framework is a solid foundation from which Congress can draft legislation. The outline simplifies the tax code, lowers taxes on individuals, and updates the business tax code so that American firms and the people they employ can be globally competitive again.

The Framework can be improved. There is no mention of lowering the tax rate on capital gains and dividends, reforming the international taxation of individual income, or repealing some of the most destructive Obamacare taxes, such as the 3.8 percent Net Investment Income Tax. The final details of almost every proposed change will be important determinants of tax reform's ultimate success in growing the economy and improving the status quo.

Tax reform that follows this most recent Framework and fulfills the promises of Republican lawmakers will unleash higher wages, create more jobs, and unveil untold opportunity through a larger and more dynamic economy.

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