NEUTRAL TAX REFORM WITH A 15 PERCENT BUSINESS INCOME TAX RATE

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August 21, 2017

ABSTRACT

The Trump administration has announced the broad outlines of a tax reform plan that contains many provisions similar to those in the House GOP tax reform "blueprint" announced last year, but there are fundamental differences in the provisions affecting businesses and investors. While different, in both plans these provisions raise serious policy issues. They are not revenue or distributionally neutral, and are not neutral among economic activities. This paper describes and analyzes an illustrative plan that retains key features of the Trump administration and House GOP plans but is far closer to revenue, distributional, and economic neutrality than either of those plans. The illustrative neutral plan has two main elements: (1) reform of the income taxation of business entities and investors, with a 15 percent rate on business entities, repeal of the 3.8 percent tax on net investment income, and integration of business and equity investor taxes; and (2) adoption of a 7.5 percent business-level consumption tax, combined with repeal of employee Medicare and all employer payroll taxes.

Jim Nunns is a Senior Fellow at the Urban-Brookings Tax Policy Center. He thanks Len Burman, Harvey Galper, Donald Marron, Mark Mazur, Joseph Rosenberg, and Eric Toder for very helpful comments, Michael Marazzi for copy editing, Philip Stallworth for checking the examples, and Lydia Austin for preparing the paper for publication. All errors and omissions are the authors'.

INTRODUCTION

On April 26, 2017, the Trump administration announced a broad outline of its tax reform plan.[1] Many provisions of the plan are similar to those in the House GOP tax reform blueprint announced June 24, 2016, by Speaker Paul Ryan (Ryan 2016). Neither plan is fully specified, and a recent joint statement by House, Senate, and Trump administration leaders indicates that some elements of the House GOP plan are no longer under consideration.[2] But no other details on tax reform are currently available and legislative proposals may draw heavily from these two plans, so the features and issues raised by these two plans remain relevant.

The two plans differ fundamentally in their provisions affecting businesses and investors. A plan consistent with the outline in the Trump administration announcement (hereafter referred to as a "Trump administration-like plan") would reduce the income tax rate on corporations as well as the rate on partnerships and other pass-through businesses to 15 percent, while the House GOP plan would convert the income tax on businesses to a border-adjustable business-level consumption tax with a 20 percent rate for corporations and 25 percent rate for pass-through businesses. Capital gains and dividends would continue to be taxed at preferential rates under both plans.

Although the business and investor provisions of the plans differ in design, they both raise serious policy issues that must be addressed during the legislative process. Neither plan includes sufficient offsets for the large revenue losses that reduced rates on business income would create, so the plans are far from revenue neutral. The plans are also far from distributionally neutral, largely because the business and investor provisions would primarily benefit the highest-income groups. Moreover, the plans either exacerbate or fail to remove several distortions of economic incentives that are caused by the current tax system. For example, the plans do not equalize the taxation of business income earned by corporations and the taxation of income earned by pass-through businesses, nor do they equalize the treatment of retained and distributed business income. Further, in both plans the combined business and equity investor tax rates are well below the rates that apply to wages, which would encourage high-wage workers to become "independent contractors," further cutting taxes at the top of the income distribution and distorting compensation arrangements and firm behavior.

Each of the non-neutralities in these plans could be addressed in alternative ways, and both the Trump administration and Congress are exploring various options. Designing a plan that would remove all these non-neutralities without creating new ones will be difficult. As a step toward designing such a fully neutral plan, this paper describes and analyzes an illustrative plan that is revenue neutral, is much closer to distributionally neutral than either the House GOP or Trump administration-like plans, and removes or significantly mitigates most of the distorting effects these plans have on economic incentives. The illustrative neutral plan has two main elements: (1) reform of the income taxation of business entities and investors, with a 15 percent rate on corporations (a key feature of the Trump administration-like plan) and a 15 percent rate on pass-through entities (the Trump administration-like plan would impose this rate on owners only), repeal of the 3.8 percent tax on net investment income (a key feature of both tax or health plans), and integration of business and equity investor taxes (a key proposal of Senate Finance Committee Chairman Orrin Hatch[3]); and (2) adoption of a business-level consumption tax (a key feature of the House GOP plan) with a single rate of 7.5 percent, combined with repeal of all employer payroll taxes and employee Medicare payroll taxes. The illustrative neutral plan also includes, for revenue purposes, the individual income and estate and gift tax provisions of the House GOP plan, but it does not address the important policy issues raised by those provisions; and it includes repeal of all Affordable Care Act taxes, which has been a key feature of the House and Trump administration health policy reforms.

DESCRIPTION OF THE PLANS

The provisions of the House GOP plan, the Trump administration-like plan, the illustrative neutral plan, and the corresponding provisions of current law are shown in table 1.[4] This section describes the provisions of the illustrative neutral plan and how they relate to the provisions of the other plans and current law.

Income Tax on Business Entities

Like the Trump administration-like plan, the illustrative neutral plan would retain a corporate income tax and reduce its rate to 15 percent,[5] repeal the corporate alternative minimum tax (AMT), and repeal several corporate tax expenditures: the domestic production activities deduction and all corporate credits (except the credit for research and development). Also like the Trump administration's plan, the illustrative neutral plan would retain an income tax on pass-through business income and set its rate at 15 percent,[6] repeal the individual AMT, and repeal the same tax expenditures as would be repealed for corporations. Unlike the Trump administration-like plan and current law, however, the illustrative neutral plan would impose this income tax at the entity level for pass-through businesses organized as partnerships or limited liability companies (LLCs).[7]

The taxation of the income of some pass-through businesses at the entity level is necessary to achieve neutral tax treatment of business income earned by pass-through businesses and corporations. As described in the following section, both the corporate income tax and the entity-level tax on pass-through businesses would be treated as withholding taxes on equity investors, so the entity-level tax would not change the total tax paid on the income of individuals and other taxable owners. Like the corporate income tax, however, the entity-level tax would result in a 15 percent tax rate on the income of foreign and tax-exempt[8] owners of partnerships and LLCs.[9] Foreign and tax-exempt investors in corporate stock would receive

TABLE 1

Provisions of Current Law and Trump Administration-like, House GOP, and Illustrative Neutral Tax Plans

Provision	Current law	House GOP plan	Trump administration-like plan	Illustrative neutral plan
Income Tax on Business Entities				
Corporations				
Base	Income (but many tax expenditures)	N/A (converted to consumption tax)	Income (repeals some tax expenditures)[a]	Income (repeals some tax expenditures)
Rate(s)	15% to 35%	N/A (converted to consumption tax)	15%	15%
Corporate AMT	20% rate on "preferences"	Repealed	Repealed	Repealed
Pass-through entities				
Base	No tax on entities; owners taxed on income (with many tax expenditures)	N/A (converted to consumption tax)	No tax on entity; owners taxed on income (with many tax expenditures)	Entity-level tax on partnership and LLC income (some tax expenditures repealed)
Rate(s)	Owners' rates; NIIT may apply	N/A	Owners' rates, capped at 15%	15%
Individual AMT	26% or 28% rate on "preferences"	Repealed	Repealed	Repealed
Individual Income Taxation of Investors (lenders, corporate shareholders and owners of pass-throughs)				
Interest	Regular rates	50% exclusion (top rate 16.5%)	Regular rates	Regular rates
Dividends (qualified)	Special rates up to 23.8%	50% exclusion (top rate 16.5%)	Special rates of 0%, 15%, 20% (in place of regular 10%, 25%, 35% rates)	"Grossed-up" dividends taxed at regular rates, with 15% credit
Capital gains (on stocks)	Special rates up to 23.8%	50% exclusion (top rate 16.5%)	Special rates of 0%, 15%, 20% (in place of regular 10%, 25%, 35% rates)	Taxed like dividends, but with deferral of gains taken into account
Pass-through distributions	Not separately taxed	Not separately taxed	Distributions from "large" pass-throughs taxed like dividends[b]	All pass-through income deemed distributed and taxed like dividends
Net investment income tax (NIIT)	3.8% (included in other rates)	Repealed (as part of health reform)	Repealed	Repealed
Consumption Tax on Business Entities				
Base	N/A	Cash flow	N/A	Cash flow + wages and fringe benefits
Rate on: Corporations		20%		7.5%
Pass-through entities		Owners' rate, capped at 25%		
Payroll Taxes				
Employer rate: Medicare	1.45% on all wages	Same as current law	Same as current law	Repealed
Social Security	6.2% on capped wages	Same as current law	Same as current law	Repealed
Employee rate: Medicare	1.45% on all wages + 0.9% on high wages	0.9% rate on high wages repealed (as part of health reform)	0.9% rate on high wages repealed (as part of health reform)	Repealed
Social Security	6.2% on capped wages	Same as current law	Same as current law	Same as current law
Other Provisions				
Individual income tax rates	10%, 15%, 25%, 28%, 33%, 35%, 39.6%	12%, 25%, 33%	10%, 25%, 35%	Assumed for revenue purposes to be same as House GOP plan
Standard deduction (joint)	$12,700	$24,000	$25,400	
Itemized deductions		Repealed (except home mortgage interest and charitable contributions)	Repealed (except home mortgage interest and charitable contributions)	
Personal exemptions	$4,050 (taxpayers and dependents)	Repealed	Repealed[b]	
Credit for dependents	$1,000 for children	$1,500 for children, $500 other dependents	Increased employer credit for child care	
Child and dependent care	Credit; exclusion for employer-provided	Repealed	New deduction; increase in EITC	
Estate and gift taxes	Rate of 40% on estates over $5.49 million	Repealed	Repealed	
Gains at death	Step-up in basis	Carryover basis	Taxed (above large exemption)[b]	
Other ACA Taxes	"Cadillac" tax, excise on medical devices, etc.	Separately repealed in health reform	Separately repealed in health reform	Repealed
One-time deemed repatriation tax	N/A	Top rate of 8.75%; paid over 8 years	Top rate of 10%; paid over 10 years	Not included for revenue purposes

Sources: Ryan (2017), Burman et al. (2017), TPC Staff (2017a), Nunns et al. (2016).
Note: ACA = Affordable Care Act; AMT = alternative minimum tax; EITC = earned income tax credit; N/A = not applicable; NIIT = net investment income tax.
(a) Also moves to a territorial system.
(b) Provision included in Trump campaign plan, but not explicitly included in Trump administration plan.

significant tax benefits from the reduction in the corporate income tax rate from 35 percent to 15 percent.

Individual Income Taxation of Investors

The illustrative neutral plan would integrate the income tax on business entities with the individual income tax on equity investors (corporate shareholders and owners of pass-through businesses), so that all income of equity owners is taxed once. Integration has been proposed (for corporations) by Senator Hatch, but it is not included in either the House GOP or Trump administration-like plan. Interest income would be taxed at regular income tax rates under the illustrative neutral plan as it is under current law and the Trump administration-like plan (but not the House GOP plan, which provides a 50 percent exclusion for interest, dividends, and capital gains). The illustrative neutral plan would also repeal the 3.8 percent net investment income tax (NIIT), which applies to dividends, capital gains, interest, and some pass-through income, a provision of the Trump administration tax reform plan and the House GOP health reform plan.

Integration would be achieved using a simplified version of the "shareholder-credit" form, in which the business income of equity investors would be treated as including the entity-level 15 percent tax, but investors would receive a credit for that tax against their individual income tax liability.[10] For example, if a corporation earned $100, it would pay corporate income tax of $15. If it distributed the remaining $85 as a dividend, the shareholder receiving the dividend would include in taxable income $100 (the $85 dividend and the $15 corporate income tax) but then receive a credit of $15 against his or her individual income tax. Shareholders in the top 33 percent individual income tax bracket (implicitly taken from the House GOP plan)[11] would calculate their tax on the dividend as 0.33 × $100 = $33, less the $15 credit, for a net tax of $18. The total tax paid on the corporation's income would be $33, the same tax that the shareholder would have paid if he or she had earned the $100 directly.

The shareholder credit would not be refundable, but it could be used to reduce income tax on other income and nontaxable individuals could carry the credit forward (with interest). In the example, the total tax paid on $100 of corporate income by shareholders in the lowest bracket (12 percent, also implicitly taken from the House GOP plan) would therefore be $12, and $0 (in present value) for a currently nontaxable individual (so for all individuals the same tax they would have paid if they had earned the $100 directly). Because the credit would not be refundable, the total tax on the $100 of corporate income for tax-exempt and foreign-entity shareholders would be the corporate income tax of $15.

Integration would only apply to "qualified" dividends received from domestic corporations, with dividends from other corporations taxed at ordinary rates as under current law.[12] Rather than requiring domestic corporations to calculate and report the actual amount of taxes they paid associated with each dividend, shareholders would simply divide qualified dividends by 85 percent, so dividends would "gross up" to the corresponding amount of pre–corporate income tax earnings, assuming those earnings had been fully taxed at the 15 percent corporate rate. Shareholders would be taxed on their grossed-up dividends but receive a credit for the assumed amount of associated corporate income tax paid.[13]

Similar computations would apply to individuals' capital gains on the sale of corporate stock of a domestic corporation, but to equalize the tax treatment of capital gains and dividends the value of deferring the shareholder's net tax would be taken into account in computing capital gains on stock. The deferral calculation would be based on a simplified method that requires shareholders to know only the amount realized from the sale of the stock and the year the stock was purchased.[14] The amount of gain from a stock sale would be computed based on the assumption that the shareholder would have earned an after-tax, risk-free rate of return on the retained earnings over the period the stock was held had the earnings been distributed each year rather than retained. Taxpayers would be provided a table showing the fraction of the sales price that represented the gain for each (current) statutory individual income tax rate and each previous year in which the stock could have been purchased.[15] The entries in the table would take into account the gross up and credit for the (presumed) 15 percent corporate income tax, so the computed gain would simply be taxed at the taxpayer's regular income tax rate.

To ensure that dividends and capital gains on stock were taxed equivalently, the tax on dividends paid from retained earnings from years before the preceding year would also be adjusted for deferral.[16] Short-term gains would be computed in the same manner as under current law, but the holding period for long-term gains would be lengthened to two years to conform with the rule for dividends.[17]

All income (after any 15 percent entity-level tax) of pass-through businesses would be deemed to be distributed currently to owners.[18] Owners of pass-through businesses taxed at the entity level (partnerships and LLCs) would gross up these deemed distributions for the entity-level tax and then receive a (nonrefundable) credit for the gross-up amount against their income tax liability. Because foreign and tax-exempt owners generally have no income tax liability, the tax rate paid on the income of these owners would be 15 percent, the same tax rate that would be paid if such owners were shareholders of a corporation. Sole proprietorships can only be owned by individuals, and S corporations must have taxable owners (resident individuals, certain trusts, and estates), so such entities would not be subject to a separate entity-level tax and owners would continue to pay individual income tax at regular rates on their pass-through income.

Consumption Tax on Business Entities

The illustrative neutral plan would adopt a business transfer tax (BTT), a broad-based, business-level consumption tax that applies at a single rate to all businesses. A BTT is also referred to as a "subtraction method" value-added tax (VAT).[19] The tax base is computed from business "transfers": receipts from the sale of all goods and services are included, and all purchases of goods and services from other businesses are deducted in a BTT. Purchases of all investment goods, such as machinery, equipment and structures, are "expensed" because, like other purchases, investment good purchases are immediately deducted. Financial transactions, such as receipt and payment of interest, are not included in computing the BTT base. A BTT, like all VATs, is also border adjusted, with exports excluded from receipts and imports nondeductible, so the BTT is destination based. Businesses would deduct BTT payments in computing taxable income for income tax purposes, just as they currently deduct payments of other business taxes (such as excise taxes and employer payroll taxes).

The single rate of the BTT under the illustrative neutral plan would be 7.5 percent, which would apply to all businesses. Note that this rate (like income tax rates, employee payroll tax rates, and the business consumption tax rates in the House GOP plan) is tax inclusive, meaning it would apply to amounts that include the tax.[20] Nonprofit institutions and governments would not be subject to the BTT, but purchases they made from businesses would be subject to BTT and they would pay a tax of 7.5 percent on the compensation (including BTT)[21] they paid to employees (in place of the employer share of the payroll tax, which would be repealed; see following section).

The House GOP plan would retain some vestiges of the business income tax base but largely would convert it into a consumption tax base by allowing expensing of most investment and disallowing deductions for net interest expense.[22] This type of business-level consumption tax is referred to as a "cash-flow tax." The House GOP plan's approximation of a cash-flow tax would be border adjusted, so would be destination based.[23]

The BTT shares some key features of the cash-flow tax in the House GOP plan: expensing of investment, disallowance of interest deductions, and border adjustments. And both would tax consumption in the US neutrally, without regard to where consumption items were produced, the form of the producer's business organization, the method used to finance production, or the location of the producer's investors. But few countries have ever enacted a cash-flow tax so design and administrative features (such as how to handle tax losses of exporters)[24] are uncertain; VATs are imposed in most countries, so design and administrative issues have been worked out.[25] Aside from uncertainty about the design of the House GOP plan's cash-flow tax, the BTT would differ from it in important ways: all investment, including purchases of inventory goods and land, would be deductible under the BTT, but not the House GOP plan's cash-flow tax; all financial transactions would be excluded from the BTT base but perhaps not from the House

GOP plan's cash-flow tax base;[26] and the BTT would be imposed at a single rate of 7.5 percent, rather than at the two much higher rates of 20 percent (for corporations) and 25 percent (for pass-through entities) in the House GOP plan's cash-flow tax. The single, low rate of the BTT is advantageous because it would have much smaller short-run effects on international trade[27] and would not encourage unproductive shifting of business activities simply to benefit from rate differentials.

The most important difference in the bases of the two business-level consumption taxes is that the BTT base would include wages and other compensation of employees, whereas the base of the House GOP plan's cash-flow tax would not. If employee compensation were deductible from the base of the BTT, the resulting tax would be a true destination-based cash-flow tax. (The House GOP plan's cash-flow tax has often been referred to as a VAT with a wage deduction.[28]) By including employee compensation in the tax base, the BTT would likely meet WTO requirements for border adjustability,[29] so it would not likely be challenged legally or create the possibility of retaliation (as would the House GOP plan's cash-flow tax).[30]

A cash-flow tax does not tax (in present value) the "normal" return to capital investment because investment is expensed, so the tax base is just "supernormal" returns (economic rents) and, for pass-through businesses, the value of any labor services provided by owners.[31] The House GOP plan's cash-flow tax would therefore not tax employee compensation or normal returns to investment. The BTT would tax all employee compensation (including the value of any labor services provided by pass-through business owners) as well as supernormal returns, but like a cash-flow tax, it would not tax normal returns to investment.

Repeal Most Payroll Taxes

To remove most of the burden of the BTT on employee compensation, the illustrative neutral plan would repeal the 7.65 percent employer payroll tax, the 1.45 percent employee Medicare tax, and the 0.9 percent additional Medicare tax imposed on high-wage workers that was enacted as part of the Affordable Care Act (ACA). The corresponding payroll taxes imposed by the Self-Employment Contributions Act (SECA) on certain owners' income from pass-through businesses would also be repealed.[32] Nonprofit and government employers would no longer be subject to the 7.65 employer payroll tax (nor would their employees be subject to Medicare taxes), but the total employee compensation paid by these employers would be subject to tax at the tax-inclusive BTT rate of 7.5 percent. The Trump administration and the House GOP tax plans would not alter payroll taxes, but their health plans would repeal the 0.9 percent additional Medicare tax.

The illustrative neutral plan would not alter the current 6.2 percent employee payroll tax for Social Security, although revenues could change some if there was any change in covered wages.[33] The same amount of revenue raised by the employee Social Security tax would be transferred from the revenues raised by the BTT to the appropriate trust funds. Because the proposal would repeal both the employer and employee Medicare taxes, no corresponding amounts would be collected in the future to guide transfers to the trust funds. However, the transfers could initially be based on a percentage of receipts from the BTT, with the percentage slowly rising over time to correspond to rising Medicare tax receipts relative to GDP under current law. These transfers could then be adjusted, if necessary, based on a calculation of Medicare revenues that would have been raised from earnings (including earnings over the threshold for the additional 0.9 percent Medicare rate) reported for employee Social Security tax purposes.

Other Provisions

The illustrative neutral plan includes the revenue cost of the individual income and estate and gift tax provisions in the House GOP plan, but it does not include any changes to address the policy issues they raise. Repeal of other "noncoverage" ACA taxes (including its excise tax on high-premium health insurance [the Cadillac tax] and the excise tax on medical devices) is also included in the illustrative neutral plan.[34]

The one-time deemed repatriation tax on the accumulated earnings of foreign subsidiaries, a provision in both the House GOP and Trump administration-like plans, is not included in the illustrative neutral plan for revenue purposes.[35] Note that the other permanent business provisions in the House GOP plan, for expensing and disallowance of interest deductions, are embedded in the BTT.

ANALYSIS OF THE PLANS

Revenue Effects

Both the House GOP and Trump administration-like plans would significantly increase deficits. For the House GOP plan, the Tax Policy Center (TPC) estimated revenue losses of $3.1 trillion in the first 10 years ($3.0 trillion when estimated dynamically—that is, including macroeconomic feedback effects) and $2.2 trillion in the second 10 years ($3.4 trillion estimated dynamically).[36] Virtually all of this revenue loss would be caused by the business and investor provisions; the individual and other provisions on net are nearly revenue neutral. TPC estimated revenue losses for the tax cut provisions in the Trump administration-like plan of $7.8 trillion (excluding macroeconomic feedback) in the first 10 years and between $7.7 trillion and $8.2 trillion on a dynamic basis.[37] In the second 10 years, these provisions would lose $13.1 trillion and between $13.8 trillion and $14.9 trillion if estimated dynamically. If revenue raising provisions from Trump's campaign proposals that may be part of the plan are included, it would lose $3.5 trillion over the first 10 years (between $3.4 trillion and $3.9 trillion if estimated dynamically) and $5.7 trillion (between $5.9 trillion and $7.0 trillion if estimated dynamically) over the second 10 years. Much of the revenue losses in all cases would be caused by the business and investor provisions.

Higher deficits under both plans could temporarily boost spending, output, and revenues, but over time they would crowd out investment and reduce output and revenues (as TPC's dynamic estimates indicate). Further, if the legislative proposals were to be considered under budget reconciliation procedures, projected revenue losses in the second 10 years would be subject to a point of order under Senate rules that would require 60 votes to overcome, so either plan could likely only be passed if it (or the rate cuts it contains) were made to expire by the end of the first 10 years. Temporary rate cuts could create significant uncertainty for businesses, investors, and workers, potentially negating much of the expected economic benefit of tax reform.

In contrast, the illustrative neutral plan is revenue neutral over the 10-year period of fiscal years 2018 through 2027 (table 2). It is also very close to revenue neutral in every year in that period and produces very small surpluses in the last two years. Note that the estimates in table 2 do not include likely positive revenues from macroeconomic feedback effects or from

TABLE 2

Ten-Year Revenue Effects of Illustrative Neutral Tax Plan

$ trillions, fiscal years 2018-27[a]

Provision	
Income Tax on Business Entities and Individual Income Taxation of Equity Investors	
1. Reduce the corporate income tax rate to 15%, repeal the corporate AMT, broaden base	-2.2
2. Tax certain pass-through entities at 15% rate, repeal individual AMT, broaden pass-through base	(b)
3. Tax interest, dividends, capital gains, and deemed pass-through distributions at regular rates, with equity returns grossed-up by, and with a credit for, the 15% corporate and pass-through entity-level tax	(b)
4. Repeal the 3.8% net investment income tax	-0.2
Consumption Tax on Business Entities and Repeal of Most Payroll Taxes	
5. Adopt a BTT with a 7.5% rate	11.3[c]
6. Repeal the 7.65% (6.2% Social Security and 1.45% Medicare) employer payroll tax	-6.5
7. Repeal the employee Medicare tax (1.45% + additional 0.9% on high-wage workers)	-1.6
Other Provisions	
8. Individual income and estate and gift tax provisions in House GOP plan (includes 2 and 3 above[d])	-0.3
9. Repeal other ACA taxes	-0.5
Net 10-year revenue effect of illustrative plan	**0.0**

Source: Urban-Brookings Tax Policy Center (TPC) Microsimulation Model, TPC off-model estimates, and author's estimates.

Note: ACA = affordable care act; AMT = alternative minimum tax; BTT= business transfer tax.

(a) Baseline is current law. All provisions would be effective January 1, 2018. Estimates do not take into account macroeconomic feedback ("dynamic") effects.

(b) Revenue effect included in line 8.

(c) Estimate is net of income and payroll tax offsets.

(d)The taxation of investors in the illustrative neutral plan differs from the taxation of investors in the House GOP plan, but the revenue effects are assumed to be similar.

improvements in compliance. Because the plan has no temporary provisions and no provisions that phase in or phase out over time, there is no reason to expect it to lose revenue after 2027. The plan should therefore meet Senate rules and could be a permanent reform.

Distributional Effects

Both the House GOP and Trump administration-like plans are far from being distributionally neutral, with most benefits of the tax cuts going to high-income households. For the House GOP plan, TPC has provided a range of estimates under alternative assumptions, all of which show disproportionate tax cuts for the highest-income households.[38] TPC's distributional estimates for the Trump administration proposal show that nearly 40 percent of the benefit of the tax cut provisions would go to the highest 1 percent of households and 72 percent to the top quintile, while nearly 50 percent of the net benefit of the combined tax cut and possible revenue raising provisions would go to the highest 1 percent of households and nearly 80 percent to the top quintile.[39]

The main driver of the distributional results under both plans are the reductions in tax rates on businesses and investors. Most of the benefit of the reduction in the corporate income tax rate would go to high-income households.[40] High-income households receive a much larger share of their income from dividends, capital gains, and pass-through income than low- and middle-income households, so the reduction in rates on these sources of income would primarily benefit high-income households. Repeal of the 3.8 percent NIIT would only benefit high-income households because that tax only applies to single taxpayers with incomes over $200,000 and married couples with incomes over $250,000.

The illustrative neutral plan addresses the distributional effects of the business and investor provisions in several ways. Regular income tax rates would apply to business income (including distributions and capital gains) under the plan, rather than the reduced rates that would apply under the House GOP and Trump administration-like plans. By imposing the same income tax rates on business income and wages, the illustrative neutral plan would remove the incentives the House GOP and Trump administration-like plans could create for high-income households to reduce their taxes by setting up a pass-through business and essentially becoming "independent contractors." And the combination of the new BTT and repeal of the entire employer and employee Medicare payroll taxes would be quite progressive, as the following examples show.[41]

The BTT tax rate of 7.5 percent would impose a lower burden on wages than the repealed payroll taxes for most workers, who earn less than the Social Security wage cap of $127,200 (in 2017). For example, each $1,000 of wages paid to most workers is currently subject to an employer payroll tax of $76.50 ($14.50 for Medicare and $62.00 for Social Security). The employee payroll tax is also $76.50 ($14.50 for Medicare and $62.00 for Social Security), so the total payroll tax on $1,000 of wages is $153.00. Under the illustrative neutral plan, the 7.5

percent BTT would be imposed on employee compensation, which is an employer's total labor costs. The total labor cost to an employer is the $1,000 of wages plus the employer payroll tax of $76.50, or $1,076.50. The BTT on this total labor cost would be 0.075 x $1,076.50 = $80.74. The illustrative neutral plan would repeal the entire employer's payroll tax of $76.50 and the employee Medicare tax of $14.50 to produce a payroll tax cut of $91.00, which is $10.26 more than the BTT. Economists generally agree that taxes on labor compensation, whether imposed on employers or employees, reduce after-tax wages, so a reduction in those taxes should increase after-tax wages. In the example just given, under the illustrative neutral plan the current $1,000 of wages (after employer, but before employee, payroll taxes) would be expected to decrease (assuming the price level is unchanged)[42] by the amount the BTT exceeds the current employer payroll tax, which is $4.24 ($80.74 - $76.50). However, after-tax wages would increase by $14.50 because the employee Medicare tax would be repealed, so on net those wages would increase by $10.26 ($14.50 - $4.24), or the amount the payroll tax cut exceeded the BTT. However, the decrease in wages would also reduce the employee's payroll tax by $0.26 ($4.24 × 0.062). The total increase in after-tax wages would therefore be $10.52, the equivalent of an increase in wages of over 1 percent. Income tax savings produced by the small reduction in wages could further increase after-tax wages.[43]

Note that wages could be expected to fall more than the example indicates for employees below the wage cap who receive compensation in the form of fringe benefits, such as employer-provided health insurance, which would be included in the BTT tax base. Some of the effect of lower wages would be offset by reductions in income tax liabilities, by repeal of the ACA Cadillac tax and any increase in the share of compensation from wages. Even with such offsets, however, employees for whom fringe benefits represent a significant share of compensation would have reduced after-tax compensation.

For high-wage workers earning more than the Social Security wage cap, the BTT would impose a higher tax burden than the repealed payroll taxes, even if all compensation was in the form of wages. For a high-wage worker, $1,000 of wages (above the cap) represents a total employer labor cost of only $1,014.50 because only the employer Medicare rate applies. The BTT on this total labor cost would be 0.075 × $1,014.50 = $76.09, whereas the repealed payroll taxes would be the employer plus employee Medicare taxes, totaling $29.00, plus, for wages above the employee's threshold,[44] an additional employee Medicare tax of $9.00, for a total of $38.00. The tax increase on most high-income workers would therefore be $38.09. However, wages for such workers would be expected to fall some to maintain the employers' total labor cost. With a BTT of $76.09, wages would need to fall to $1,014.50 - $76.09 = $938.41, or by $61.59. But some of this reduction in wages would be offset by the repeal of the employee's Medicare taxes ($23.50) and the tax savings produced by the reduction in taxable wages for income tax purposes, which at the 33 percent top rate (implicitly taken from the House GOP plan) would be 0.33 × $61.59 = $20.32. The reduction in after-tax wages would therefore be $61.59 - $23.50 - $20.32 = $17.77, a loss that could be more than offset by the employee's savings from lower-income tax rates. For example, if the employee was in the top current bracket of 39.6 percent, a reduction in the rate to 33 percent would reduce the income tax on his or her current wages of $1,000 by $66.00. As was true with lower-wage workers, however, the BTT would apply to fringe benefits like employer-provided health insurance, and that would lead to an additional reduction in wages (or fringe benefits) that might not be offset by income tax rate cuts and repeal of the ACA Cadillac tax.

Apart from employee compensation, the BTT would impose a burden on supernormal returns to investment and the value of any labor services provided to pass-through businesses by owners, although part of that burden would be offset by the repeal of most SECA payroll taxes and the NIIT. High-income households receive most of the income from both sources, so this burden would be distributed quite progressively.

Although the illustrative neutral plan addresses the distributional effect of the business and investor provisions, it does not address the distributional effect of the other provisions in the House GOP or Trump administration-like plans, which provide large income tax rate cuts for high-income households and repeal the estate and gift taxes; they are therefore almost certainly not distributionally neutral. The distributional effect of a complete tax reform proposal that included the business and investor provisions of the illustrative neutral plan would therefore depend on how these other provisions were changed during the legislative process from how they are specified in the House GOP and Trump administration-like plans.

Economic Incentives

Current law has many adverse effects on economic incentives. Many of these adverse incentives encourage taxpayers to engage in costly tax avoidance activities that divert resources from productive economic activities. The House GOP and Trump administration-like plans mitigate, but do not eliminate, some of these adverse economic incentives, but these plans also create new adverse incentives and exacerbate some existing ones. The illustrative neutral plan, in contrast, eliminates some of the adverse economic incentives of current law or generally mitigates them more than the other two plans, and it does not create new adverse incentives.[45]

Form of Business Organization

Under both the House GOP and Trump administration-like plans, as under current law, some amount of corporate income would be taxed at the corporate level and again at the shareholder level when distributed as dividends or, if retained, when realized as a capital gain on the sale of the stock. Under the Trump administration-like plan, for example, if a corporation earned $100 of income, it would pay $15 of corporate income tax. If the corporation distributed the remaining $85 as a dividend to a shareholder in the highest (35 percent) individual rate bracket, the dividend would be taxed at 20 percent, for a tax of $17. The total taxes paid on the corporation's $100 of income would be $32. A shareholder in the lowest (10 percent) bracket would not be taxed on the dividend, so the total tax paid on the corporation's $100 of income would be the $15 of corporate income tax. If the shareholder was a nontaxable individual or a tax-exempt or foreign entity, the $15 of corporate income tax would also be the only tax paid.

Under the House GOP plan, the corporate tax base is cash flow, so only the portion of income that represented supernormal returns would be taxed (in present value). TPC assumes that, on average, 40 percent of the earnings of corporations represent normal returns and the remaining 60 percent represent supernormal returns. So, for example, if a typical corporation earned $100 of income, it would have a cash flow base of $60 and pay tax of 0.20 × $60 = $12.[46] If the corporation distributed all of its after-tax income and all of that distribution was treated as a dividend, the shareholder would exclude half of it, so the taxable dividend would be ($100 - $12) × 0.50 = $44.00, on which a top-bracket taxpayer would pay $14.52 (0.33 × $44.00) in income tax.[47] The total tax paid on the corporation's $100 of income would be $26.52. A shareholder in the lowest (12 percent) bracket would pay $5.28 in income tax on the dividend, so the total tax paid on the corporation's $100 of income would be $17.28. If the corporation earned only normal returns, it would pay no corporate-level tax (in present value), so the dividend would be $100, on which a shareholder in the highest bracket would pay $16.50 in tax and a shareholder in the lowest bracket would pay $6.00 in tax. If the corporation earned only supernormal returns, the corporate-level tax would be $20 and the dividend would be $80, on which a shareholder in the top bracket would pay $13.20 in tax (for a total tax of $33.20) and a shareholder in the bottom bracket would pay $4.80 in tax (for a total tax of $24.80). If the shareholder was a nontaxable individual or a tax-exempt or foreign entity, the only tax paid would be the corporate-level tax.

Both plans would retain the current-law taxation of the earnings of pass-through businesses only at the owner level, with the Trump administration-like plan possibly imposing an additional tax on distributions from "large" pass-through businesses.[48] The total tax paid on $100 of income earned by a pass-through business that was not large under the Trump administration-like plan would be $15 for an owner in the top 35 percent bracket, $10 for owners in the 10 percent bracket, and $0 for owners that were not subject to income tax (including tax-exempt and foreign entities, which can be owners of partnerships and LLCs). If the pass-through business was large and all after-tax income was distributed (or treated as distributed), the total tax paid if the owner was in the 35 percent bracket would be $32 (the same as on $100 of income earned in a corporation), but it would still be $10 for owners in the 10 percent bracket and $0 for owners not subject to income tax.

Under the House GOP plan, if a pass-through business that earned $100 of income had a mix of 40 percent normal returns and 60 percent supernormal returns (and no income that represented the value of labor services provided by owners), the total tax paid would be $60 ×0.25 = $15 for an owner in the top 33 percent bracket, $60 × 0.12 = $7.20 for an owner in the lowest bracket, and $0 for owners not subject to income tax (including tax-exempt and foreign entities), regardless of the size of the pass-through business or whether any of its income was actually distributed. If the pass-through business earned only normal returns, no tax would be paid by any owner. If the pass-through business earned only supernormal returns or the value of labor services provided by owners, an owner in the capped 25 percent bracket would pay $25 in tax, and an owner in the lowest bracket would pay $12 in tax. No tax would be paid, regardless of a pass-through business's source of income, if the owner was a nontaxable individual or a tax-exempt or foreign entity.

The results of these examples expressed as effective tax rates, as well as the results of comparable examples provided in the description of the illustrative neutral plan and of comparable examples for current law, are summarized in table 3. Note that the effects of the BTT are not included in table 3 because the BTT applies equally to all businesses, so it would not affect organizational form choices. The results show that although both the House GOP and Trump administration-like plans would generally reduce the disparity in effective rates between income earned by corporations and income earned by pass-through businesses, disparities would remain in nearly all circumstances and could be even larger than under current law.[49] Because of those disparities, significant tax incentives to organize a business as a pass-through rather than a corporation would remain under both the House GOP and Trump administration-like plans.

The illustrative neutral plan, in contrast, would eliminate disparities in the tax treatment of income earned in corporations and pass-through businesses, so it would have a neutral effect on how businesses choose to organize.

Distribute or Retain Earnings

Currently, a shareholder is taxed if a corporation distributes its current after-tax earnings as a dividend, but the shareholder can defer the payment of tax on the gain in the value of stock produced by retained earnings until the shares are sold. The present value of the shareholder's tax on a stock gain will therefore be less than the tax on dividends so long as capital gains and dividends are taxed at the same rates (as they are under current law and all of the plans). The value of deferral increases with the holding period, tax rates, and the (after-tax) rate of return. The House GOP and Trump administration-like plans, like current law, apply the same tax rates to dividends and capital gains with no adjustment to the amount of the gain for the value of deferral. This tax treatment creates an incentive for corporations with taxable shareholders to retain, rather than distribute, their after-tax earnings, and for taxable shareholders to prefer investing in stocks of corporations that retain earnings. It also creates a "lock-in" effect that discourages investors from realizing capital gains.[50]

The illustrative neutral plan removes these tax distortions by adjusting capital gains on stock for the value of deferral.

TABLE 3

Effective Tax Rates on Income Earned by Corporations and Pass-through Entities under Current Law and the Trump Administration-like, House GOP, and Illustrative Neutral Tax Plans[a]

Shareholder or owner/business organization		Current law[b]	House GOP plan[c]	Trump administration-like plan[d]	Illustrative neutral plan[e]
Individual in top bracket					
Corporation		50.5%	16.5% to 33.2%	32%	33%
Pass-through entity	Small	43.4%	0% to 25%	15%	33%
	Large			32%	
Individual in lowest bracket					
Corporation		35%	6% to 24.8%	15%	12%
Pass-through entity	Small	10%	0% to 12%	10%	12%
	Large			10%	
Individual who is nontaxable					
Corporation		35%	0% to 20%	15%	0%[f]
Pass-through entity	Small	0%	0%	0%	0%[f]
	Large			0%	
Tax-exempt or foreign entity					
Corporation		35%	0% to 20%	15%	15%
Pass-through entity	Small	0%	0%	0%	15%[g]
	Large			0%	

Source: Author's calculations.

(a) All effective tax rates are calculated under the assumption that all income (after any entity-level tax) is distributed. Effective rates do not include the effect of tax expenditures that narrow the base of business taxes, phaseins and phaseouts in the individual income tax, or taxes that may apply in certain circumstances to tax-exempt and foreign entities.

(b) Corporate rate is 35%; the top regular individual rate is 43.4% (including NIIT) and lowest is 10% with corresponding special rates on dividends of 23.8% and 0%; all pass-through income of individual owners is taxed at regular rates and assumed to be subject to NIIT.

(c) Corporate rate is 20%; the top regular individual rate is 33% and lowest is 12%, half of dividends are excluded; all pass-through income of individual owners is taxed at regular rates capped at 25%. Both corporations and pass-throughs taxed on cash flow (not income), with the share of supernormal returns subject to tax ranging from 0% to 100% (reflected in the range of effective rates shown). Pass-through owners are assumed not to provide any labor services to the pass-through.

(d) Corporate rate is 15%; the top regular individual rate is 35% and lowest is 10% with corresponding special rates on dividends of 20% and 0%; all pass-through income of individual owners is taxed at regular rates capped at 15%.

(e) Corporate rate is 15%; partnerships and LLCs are taxable at the entity level at 15%; the top regular individual rate is 33% and lowest is 12%; dividends and distributions from taxable pass-throughs taxable are grossed up for the entity-level tax, with a non-refundable credit allowed to shareholders and owners for that tax; all pass-through income (after any entity-level tax) is deemed distributed and taxable to individual owners at regular rates. The effects of the BTT are not included.

(f) Effective tax rates are shown as zero for corporations and all pass-throughs (including partnerships and LLCs, which are subject to entity-level tax) because shareholders and owners of taxable entities could carry forward a credit (with interest) for the entity-level tax.

(g) Tax-exempt and foreign entities can be owners only of pass-through entities subject to entity-level tax (partnerships and LLCs).

Debt versus Equity Finance

Businesses can finance investment either through debt (borrowing from lenders) or through equity (selling stock in corporations and ownership shares in pass-through businesses). Under an income tax, the income generated by investments financed by debt is (approximately) offset by the business deduction for interest paid, but that interest is taxed at lenders' income tax rates (which may be zero). The income generated by corporate investments financed by equity is taxed at the corporate income tax rate and, when distributed as a dividend or realized as a capital gain, at the shareholders' income tax rates (which may be zero); the income generated by equity-financed pass-through investments is taxed at the owners' income tax rates (which may be zero).

As shown in table 3, under current law, the tax rates on returns to corporate equity (i.e., to shareholders) are uniformly higher than the tax rates on returns to corporate lenders (which are the same rates as those for pass-through income except for interest paid to foreign entities, which is usually taxed at a low or zero rate but can taxed at up to 30 percent).[51] So current law encourages corporations to use debt rather than equity financing.

The cash-flow business tax in the House GOP plan does not tax the "normal" return to investment, because investment is expensed. As a result, even though businesses would no longer be able deduct interest, it would not be taxed at the corporate level (or to owners of pass-through businesses), because interest generally represents just the normal return (adjusted for risk). Whether interest received on loans to businesses is taxable to nonbusiness lenders is not clearly specified under the House GOP plan. Under the assumption that it is not, Burman et al. (2017) found that the plan would slightly encourage corporations to use equity over debt financing. If nonbusiness lenders are taxable under the plan, equity financing would be encouraged even more.

Under the Trump administration-like plan, effective tax rates on returns to corporate equity (32 percent, and lower if the corporation retains earnings) are lower than the 35 percent an individual in the top bracket would pay on interest from lending to a corporation. This would reverse the much larger differential under current law. The rates on equity are higher than on debt for an individual investor in the lowest bracket or who is nontaxable, or for tax-exempt entities, but the differences are generally much smaller than under current law (for all these investors, the rate on interest is the same as on pass-through income; for foreign entities, the rate would range from 0 to 30 percent). On balance, the Trump administration-like plan may retain a small bias toward debt over equity financing for corporations.[52]

Under the illustrative neutral plan, the income taxes on businesses and equity investors are integrated and capital gains are adjusted for deferral, so regular income tax rates would always apply to the corporate equity income of all individual shareholders; this is the same rate they would pay on interest on loans to a business. However, for shareholders that were tax-exempt or foreign entities the tax rate on equity returns would be 15 percent, whereas the tax rate on interest would be 0 percent for tax-exempt entities but range from 0 to 30 percent for foreign entities. The BTT would not tax the normal return to investment, so it would not tax interest. The illustrative neutral plan would therefore substantially mitigate the current law bias for debt over equity financing for corporations, but it would not eliminate it.

For pass-through businesses, the House GOP and Trump administration-like plans would create a difference between the rate paid on equity returns and interest received by individuals in the top rate bracket, and the House GOP plan would typically do the same for individuals in the lowest rate bracket. Under the illustrative neutral plan, as under current law, individual investors have the same tax rates on returns to equity- and debt-financed investment of pass-through businesses. Under the House GOP and Trump administration-like plans, as under current law, tax-exempt and foreign-entity investors would not pay tax on pass-through equity returns, but interest paid to foreign entities would be taxed at withholding rates ranging from 0 to 30 percent. Under the illustrative neutral plan, equity returns of partnerships and LLCs would be taxed at the 15 percent entity rate, while interest paid to foreign entities would continue to be taxed at rates ranging from 0 to 30 percent. Most of the borrowing by pass-through businesses is currently in the form of mortgages on structures,[53] so it is not clear how much effect any of these differences in tax rates between equity and debt finance would have on pass-through businesses' financing choices.

Form of Income

Wages are subject to income tax at ordinary rates under both the House GOP and Trump administration-like plans, as they are under current law. Further, under both plans and current law, wages are subject to payroll taxes for Social Security and Medicare, although the additional 0.9 percent Medicare rate on high-wage workers would be repealed as part of the House, Senate, and Trump administration health policy reforms.

Current law provides an incentive for owners of certain pass-through entities to characterize their share of the income of the business as "profit" (returns to equity), subject only to income tax, rather than as labor income that would also be subject to payroll taxes. For high-income owners, this incentive may be reduced because some of the income from pass-through entities that is not subject to payroll taxes is subject to the NIIT at the same 3.8 percent rate as the Medicare tax on labor income above the threshold for the 0.9 percent additional rate. By repealing he NIIT, both the House GOP health plan and the Trump administration tax plan would exacerbate this adverse payroll tax incentive.

Under the House GOP plan, the top income tax rate on wages would be 33 percent, whereas the top rate on pass-through income would be 25 percent. Under the Trump administration-like plan, the top income tax rate on wages would be 35 percent and the middle rate 25 percent, whereas the top rate on pass-through income would be 15 percent (or 32 percent for a highest-bracket owner and 28 percent for a middle-bracket owner if the pass-through was "large"[54]). Earning labor income through a pass-through entity as an "independent contractor" would therefore reduce income taxes for a highest-bracket worker in both plans and for a middle-bracket worker under the Trump administration-like plan if the pass-through wasn't "large"; that would be a new tax incentive for such recharacterization of wages not found in current law. Many current employees might therefore shift to being "independent contractors" under both plans, even if they could not avoid any payroll taxes.[55]

Under the illustrative neutral plan, all business income of individuals would be taxed at regular income tax rates (the same income tax rates that would apply to wages), and all forms of employee compensation, including the value of all labor services provided by owners of pass-through businesses, would be taxed at the BTT rate. The plan would therefore not create a new incentive for workers to become "independent contractors," but rather it would reduce the current law incentives by repealing most payroll taxes and the NIIT.

Although the House GOP and Trump administration-like plans might have rules intended to discourage employees from becoming "independent contractors," experience from attempts to devise and administer rules to counter the incentives under current law indicate that such rules are extremely complex, costly to comply with, and not very successful. Addressing this issue with neutral rates, as the illustrative neutral plan would do, is a better approach.

The House GOP plan, like current law, provides a lower rate on capital gains than would apply to other sources of income. The current-law incentive to characterize income as capital gains (as is done, for example, with "carried interest") would therefore be retained under the plan. The Trump administration-like plan would also tax capital gains at lower rates than most sources of income, but not at a lower rate than is applied to income of small pass-throughs for owners in the top bracket; taxpayers would still have incentives to characterize certain income as capital gains and a new incentive to characterize certain income (in addition to wages) as pass-through income. All sources of income are taxed at the same rate under the illustrative neutral plan, so none of those incentives to recharacterize income would remain (or newly arise).

Wages versus Fringe Benefits

All of the plans would reduce individual income tax rates, which would mitigate some of the current-law incentive for workers to receive compensation in the form of fringe benefits, such as health insurance, rather than wages. However, the illustrative neutral plan would further reduce this incentive by replacing most payroll taxes (which do not apply to health insurance and certain other fringe benefits) with a BTT that would apply uniformly to all forms of employee compensation.

Other Economic Incentives

All of the plans would have additional effects on economic incentives. For example, corporate integration and the reduced corporate income tax rate in the illustrative neutral plan would reduce incentives for US corporations to shift profits and retain earnings abroad, and to merge into a foreign parent corporation ("invert").[56] The border adjustments in the House GOP and illustrative neutral plans' business-level consumption taxes would likewise reduce (or remove) incentives for US corporations to produce abroad, source income in lower-tax jurisdictions, and to invert. The consumption taxes would also largely avoid the income tax distortions of investment and savings decisions.[57] Lower and uniform tax rates and broader tax bases, a major feature of the illustrative neutral plan (but less so of the other plans) would reduce incentives to avoid and evade taxes.

CONCLUDING OBSERVATIONS

The illustrative neutral plan demonstrates that it is possible to design a reform that includes a 15 percent business income tax rate; that taxes businesses, investors and wages neutrally; that is revenue neutral, and that could be distributionally neutral. Many details of the plan would need to be specified for it to be workable, and many other areas should be addressed in a full tax reform proposal. Some particular areas that need to be addressed include additional broadening of both the individual and corporate income tax bases, which would reduce tax distortions and could finance distributionally neutral income tax and BTT rate reductions.[58] A workable set of international tax rules for multinational corporations need to be developed as well. To operate in an effective, fully neutral way, the deferral charge for capital gains on domestic corporate stock needs to be extended to all capital gains, including unrealized gains at death and in gifts (a critical extension if the estate and gift taxes are repealed). And the family and work-related individual income tax provisions, which affect nearly everyone, should be further simplified and made fairer.[59]

NOTES

[1] See "2017 Tax Reform for Economic Growth and American Jobs," the White House, accessed July 14, 2017, http://taxprof.typepad.com/files/trump-tax-plan.pdf. The plan is also discussed in the administration's fiscal year 2018 Budget (Office of Management and Budget 2017).

[2] See the joint statement by House Speaker Paul Ryan, Senate Majority Leader Mitch McConnell, Treasury Secretary Steve Mnuchin, National Economic Council Director Gary Cohen, Senate Finance Committee Chairman Orrin Hatch, and House Ways and Means Committee Chairman Kevin Brady, "Joint Statement on Tax Reform," July 27, 2017, http://www.speaker.gov/press-release/joint-statement-tax-reform.

[3] See Orrin Hatch, "Hatch Statement at Finance Hearing on Corporate Integration," May 17, 2016, https://www.finance.senate.gov/chairmans-news/hatch-statement-at-finance-hearing-on-corporate-integration; and Orrin Hatch, "Hatch Statement at Finance Committee Hearing on Corporate Integration," May 24, 2016, https://www.finance.senate.gov/chairmans-news/hatch-statement-at-finance-committee-hearing-on-corporate-integration.

[4] Burman et al. (2017) provide a complete description and analysis of the House GOP plan. TPC Staff (2017a) provide a description of the Trump administration-like plan, noting provisions that were in the campaign plan that may (or may not) be included. TPC Staff (2017b) provide an analysis of what is, or may be, included in the Trump administration-like plan.

[5] A 15 percent corporate income tax rate is also a key feature of the proposals by Graetz (2010), Grubert and Altshuler (2016), and Toder and Viard (2016), but those proposals do not extend that rate to pass-through entities as do the Trump administration-like and the illustrative neutral plans.

[6] Under the Trump administration-like plan, 15 percent is a rate cap; for owners in the 10 percent bracket, that rate would apply.

[7] The proposal would retain the current-law tax exemption from tax of nonprofit entities if they served tax-exempt purposes. Because of the way equity investors would be taxed, described in the following section, it would not be necessary to collect the entity level tax on sole proprietorships and S corporations. Note that under current law Subchapter S corporations are taxed at the entity level on passive income and certain built-in gains.

[8] Tax-exempt entities include retirement funds (IRA, 401(k)-type plans, and defined benefits plans, as well as 501(c)(3) organizations.

[9] Sole proprietorships and S corporations cannot have foreign or tax-exempt owners.

[10] This form is also referred to as "imputation-credit" integration. Note that it differs from the "corporate dividend deduction" form of integration that Senator Hatch proposes, under which corporations deduct dividends paid. Senator Hatch's proposal would also impose a withholding tax on dividends. The shareholder-credit and corporate dividend deduction (plus withholding on dividends) are equivalent forms of integration if the corporate and withholding tax rates are the same, as they would be under the illustrative neutral plan (Graetz and Warren 2016).

[11] The revenue effects of the illustrative neutral plan are based on the individual income tax rates in the House GOP plan, so the plan implicitly uses those rates.

[12] In limited circumstances, dividends paid by foreign corporations can be "qualified" under current law.

[13] By assuming corporate income tax was paid in this way, the value of all remaining corporate tax preferences (such as percentage depletion for oil and gas) would be passed through to shareholders. Broadening the corporate income tax base would reduce the gap between the actual and assumed corporate income tax associated with dividends. Even if all preferences were removed, however, a gap would remain for multinational corporations to the extent their foreign-source income was not taxed by the US (Graetz and Warren 2016).

[14] See Auerbach (1991) for a full description and analysis of this approach to taxing capital gains.

[15] The table would be based on the assumption that the corporation earned the presumptive rate of return in each year of the holding period, was taxed at 15 percent on all earnings, and retained all earnings. Auerbach (1991) shows that a precise calculation would require taking into account all prior corporate income tax rates, all prior distributions made by the corporation to the shareholder, and the shareholder's tax on each of those distributions. The proposed method would greatly simplify the calculation but would not be precise.

[16] Corporations would therefore be required to report to shareholders the amount (if any) of dividends that were paid from earnings in the second preceding year, the third preceding year, etc.

[17] Shareholders would therefore be required to keep records of basis and compute gain as the excess of sales price over basis for the first two years stock (of a domestic corporation) was held, but thereafter would use the simplified method for computing gain.
[18] As under current law, losses would also pass through to owners and could offset other income, with any excess carried forward (but unlike current law with interest). In this respect, the taxation of pass-through entities would differ from that of corporations (for which, as under current law, losses would be carried forward rather than passing through to owners, but unlike current law with interest).
[19] Senator Ted Cruz proposed a BTT (although he did not refer to it as such) during his presidential campaign, and BTT legislative proposals were made by Senators Boren and Danforth in 1994 and by Representative Gibbons in 1996. A BTT and a credit-invoice VAT (the form of VAT imposed in over 160 countries) would have identical tax bases if there were no exemptions and a single tax rate. See "The Simple Flat Tax Plan," Cruz 2016 campaign, accessed July 14, 2017, https://www.tedcruz.org/tax_plan/index.html.
[20] Tax rates for VATs, sales taxes, and other consumption taxes are typically expressed on a *tax exclusive* basis, meaning the tax base excludes the tax. The tax exclusive rate of the BTT would be 1/(1-.075) - 1 = 0.081, or 8.1 percent.
[21] Excluding the BTT, the rate on employee compensation would be 8.1 percent (see preceding endnote).
[22] See Weisbach (2017a) for a detailed discussion of the issues that would need to be addressed to make the business tax in the House GOP plan a true cash-flow tax.
[23] See Auerbach et al. (2017) for a detailed description and analysis of destination-based cash-flow taxes.
[24] The House GOP plan would require net operating losses to be carried forward (with interest), so exporters might never receive the tax benefit from deducting exports. The plan's border adjustments would therefore not neutrally affect trade, even with full exchange rate adjustments. The BTT would allow a refund for losses of exporters (and other companies with losses, such as start-ups and companies with large investment purchases), so would neutrally affect trade.
[25] "Modern" VATs, and in particular New Zealand's, provide much better models for design and administrative provisions than the older European-style VATs. To function properly, the BTT must be "closed" like a credit-invoice VAT, with deductions allowed only for purchases subject to BTT (Grinberg 2009; Weisbach 2017b).
[26] As in VATs, special rules would be required for financial institutions, with New Zealand's rules providing a useful guide.
[27] This would be true even if the cash-flow tax in the House GOP plan was phased in over several years. A revenue neutral phase in of the BTT and other business provisions could easily be developed to mitigate concerns about short-run dislocations due to international trade or other effects. However, phasing in any broad-based consumption tax could also create dislocations (such as incentives to delay or accelerate income, deductions, sales, and investment), so should be carefully considered.
[28] See, for example, Auerbach et al. (2017) and Paul Ryan's web page, "A Destination-Based Tax Code to Increase American Competitiveness," January 19, 2017, accessed July 14, 2017, http://www.speaker.gov/general/destination-based-tax-code-increase-american-competiveness. The deduction would actually be for total employee compensation (wages plus fringe benefits), not just wages.
[29] See OECD (2015), which explicitly includes a subtraction method VAT in the international guidelines for border adjustability.
[30] See, for example, Cui (2016), Schoen (2016), and Weisbach (2017b).
[31] Owners of S corporations are treated as employees and paid wages and fringe benefits, but owners' wages may be understated in order to reduce payroll taxes (see discussion in section on economic incentives).
[32] All income from sole proprietorships is subject to SECA, as is the income of general partners of partnerships. But the income of limited partners and of owners of LLCs is not (or may not be) subject to SECA, nor is the non-wage income of the owners of Subchapter S corporations. Some, but not all, of the income of owners of pass-throughs that is not subject to SECA is subject to the NIIT.
[33] The example in the section on distributional effects shows covered wages (i.e., wages below the Social Security wage cap) falling about 0.4 percent due to the BTT, assuming the price level was unchanged. Covered wages might not change at all (in nominal terms) if the Federal Reserve accommodated the introduction of the BTT with a small change in the price level. The Social Security benefit formula could be adjusted for any change in the level of nominal covered wages due to the BTT so that benefit levels for current workers would be maintained.
[34] The premium credits and mandates on employers and employees are "coverage" provisions and not repealed by the illustrative neutral plan. Repeal of all (noncoverage) ACA taxes was included in TPC's estimates of the House GOP tax plan (Burman et al. 2017), although repeal of these taxes was part of the 2016 House GOP health plan rather than its tax plan (that repeal has now been passed by the House as part of the American Health Care Act). Note that repeal of the 3.8 percent net investment income tax is one of the equity investor provisions of the illustrative neutral plan, and the 0.9 percent additional Medicare rate on high-wage workers is among the payroll taxes repealed.
[35] Any reduction in the corporate income tax rate would automatically reduce the deferred US tax on unrepatriated earnings of foreign subsidiaries, a windfall gain to US multinational corporations. A one-time deemed repatriation tax would remove some or

all of this windfall, but the revenue is temporary. The illustrative neutral plan includes a deemed repatriation tax, but because the plan is intended to be revenue neutral over time the revenue from that tax is not included.
[36] See tables 2 and 3 in Burman et al. (2017). Revenue losses on a dynamic basis are larger than on a static basis in the second ten years due to higher government borrowing that crowds out private investment.
[37] See TPC Staff (2017b)
[38] See table 5 in Burman et al. (2017).
[39] See tables 3 and 4 in TPC Staff (2017b).
[40] See Nunns (2012) for a discussion of the incidence of the corporate income tax and the assumptions TPC follows in distributing corporate tax changes. Under TPC's assumptions, workers would receive 20 percent of the benefit of a reduction in the corporate income tax rate.
[41] Nunns and Rosenberg (2016) shows the progressive distributional effects of similar proposals.
[42] A constant price level is the standard assumption followed by the Congressional Joint Committee on Taxation staff for purposes of estimating the revenue effects of tax proposals. Consumer prices would rise if the Federal Reserve accommodated the introduction of the BTT with an increase in the money supply. Any price increase would be small, however, because (as the example shows) the combined effect of introduction of a BTT and repeal of employer payroll taxes would have a small effect on wages of most workers.
[43] As noted in table 2, the reduction in income and payroll taxes caused by the BTT (under the standard revenue estimating assumption that the price level would not rise) is included in the revenue estimate for the BTT.
[44] The threshold for the additional 0.9 percent Medicare tax is wages of $200,000 for single, head-of=household, and surviving=spouse filers, $250,000 for joint filers, and $125,000 for married-filing-separate filers.
[45] The BTT would increase incentives that exist under current federal excises and customs duties, as well as under state and local sales taxes, for businesses (and households purchasing directly from abroad) to understate imports and for businesses to overstate exports. However, international cooperation in enforcement of value-added taxes and proper design of the BTT could help minimize such tax avoidance behaviors.
[46] These calculations reflect the present value of the tax savings caused by deferral.
[47] It is not clear under the House GOP plan whether distributions from a corporation would be taxable as a dividend only to the extent of accumulated earnings of supernormal returns, or to the extent of accumulated earnings of both normal and supernormal returns. If only dividends paid from after-tax supernormal returns were treated as taxable dividends (and the remainder of the dividend as a return of capital), in the example a shareholder in the top 33 percent bracket would exclude half the dividend (of $60 - $12 = $48) so pay tax of 0.33 x $24.00 = $7.92, and the total taxes paid on the corporation's $100 of income would be $19.92.
[48] This was a provision of the Trump campaign plan but not explicitly included in the Trump administration-like plan. The campaign plan did not define "large" or how such distributions would be measured.
[49] The only circumstance under which there would be no disparity would be for top bracket individual shareholders and owners of "large" pass-throughs under the Trump administration-like plan (and as shown later this equivalence disappears if the corporation retains any after-tax earnings). The disparity would be larger than under current law for top-bracket taxpayers under the House GOP plan.
[50] Capital gains tax can be avoided altogether on certain gifts of appreciated property to charities (subject to limits). Under current law, tax can also be avoided for gains held until death. The House GOP and Trump administration-like plans only partially address gains at death (neither would make any adjustment for deferral).
[51] The effective rates in table 3 were calculated under the assumption that the corporation distributed all of its after-tax (equity) earnings as a dividend, so the rates on corporate equity for a top-bracket taxpayer could be lower than shown if the corporation retained some or all of those earnings. However, effective rates on debt are typically lower than on pass-through income because businesses can deduct the inflation premium in interest rates (which represents a reduction in principal, not the time value of money), because accelerated cost recovery methods provide a subsidy to debt returns, and because interest deductions can be sometimes be taken before the lender is taxed on the interest. Tax rates on interest paid to foreign entities vary due to separate statutory income tax provisions for withholding tax on payments to foreign entities and provisions of income tax treaties the US has negotiated with other countries. No plan amends these statutory provisions or tax treaties.
[52] Nunns et al. (2016) found the Trump campaign plan had a small bias toward equity financing, but in that plan the tax on businesses was a cash-flow tax rather than an income tax.
[53] This information is based on tables in the Financial Accounts of the United States, produced quarterly by the Board of Governors of the Federal Reserve System.
[54] It is unclear whether the Trump administration-like plan retains this provision from the Trump campaign plan.
[55] See Rohaly, Rosenberg, and Toder (2017) for examples of how such shifting in response to differentials between tax rates on business income and wages could affect revenues.
[56] See Graetz and Warren (2016) for a discussion of these benefits from integration.

[57] To the extent supernormal returns are simply economic rents, the effects of any consumption tax on these decisions are likely to be small. However, the incentives for highly talented individuals to develop new products and services that generate supernormal returns might be adversely affected.

[58] The tax reform proposed in 2014 by former Ways and Means Committee Chairman David Camp (Joint Committee on Taxation 2014a and 2014b) contains many well-developed base broadening provisions, as does the Obama administration's fiscal year 2017 Budget (Office of Tax Policy 2016).

[59] A comprehensive reform of the family and work provisions is described and analyzed by Nunns, Maag, and Nguyen (2016).

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