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Foreword—The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy

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ABSTRACT. By lowering the corporate tax rate from 35% to 21%, the 2017 tax legislation brought the U.S. statutory rate into closer alignment with the rates applicable in other Organisation for Economic Co-operation and Development (OECD) nations, thereby decreasing the incentive for businesses to locate their deductions in the United States and their income abroad. Its overhaul of the U.S. international income tax rules simultaneously reduced preexisting incentives for U.S. multinationals to reinvest their foreign earnings abroad and put a floor on the benefits of shifting profits to low-tax jurisdictions. The 2017 legislation also added an unprecedented, troublesome lower rate for the income of certain categories of businesses operated as partnerships or Subchapter S corporations.

In combination, the provisions of the new law have created significant new differences in income tax based on what kind of business is being conducted, where goods and services are bought and sold, to and from whom they are bought, where and how assets are owned, the taxpayer's size, whether individual workers are employees or independent contractors, and where people live and work. The 2017 law also portends unsustainable increases in deficits and the national debt. The new tax system produced by this legislation provides neither an effective nor stable solution to the nation's economic and fiscal challenges.

INTRODUCTION

The 2017 tax legislation is an important revision of the U.S. income tax code. By lowering the corporate tax rate from 35% to 21%, it brings the U.S. statutory rate into closer alignment with the rates applicable in other Organisation for Economic Co-operation and Development (OECD) nations, thereby decreasing the incentive for businesses to locate their deductions in the United States and their income abroad. Its overhaul of the U.S. international income tax rules simultaneously reduced preexisting incentives for U.S. multinationals to reinvest their foreign earnings abroad and put a floor on the benefits of shifting profits to low-tax jurisdictions. The 2017 legislation also added an unprecedented, troublesome lower rate for the income of certain categories of businesses operated as partnerships or Subchapter S corporations, regardless of how large they are or how much income they earn. Along with numerous other changes in the income taxation of individuals, Congress eliminated deductions for the business expenses of employees and put a $10,000 cap on deductions for state and local income and property taxes.

In combination, the provisions of the new law have created significant new differences in income tax based on what kind of business is being conducted, where goods and services are bought and sold, to and from whom they are bought, where and how assets are owned, the taxpayer's size, whether individual workers are employees or independent contractors, and where people live and work. The 2017 law also portends massive and unsustainable increases in deficits and the national debt. The new tax system produced by this legislation provides neither an effective nor stable solution to the nation's economic and fiscal challenges.

To understand the 2017 tax legislation and its implications for the future, it is important to review the process that led to its enactment. That is where this Essay begins.

I. THE PASSAGE OF THE 2017 TAX LEGISLATION—FROM ONE PAGE TO MORE THAN 500[1]

Whatever its political and economic benefits or costs, the 2017 tax act took an unprecedented path to enactment. In April 2017, President Trump provided a page of principles and another half-page outlining some specific goals for tax reform.[2] Three months later, the self-named "Big Six"—Secretary of the Treasury Steven Mnuchin, National Economic Council (NEC) Director Gary Cohn, Senate Majority Leader Mitch McConnell, Senate Finance Committee Chairman Orrin Hatch, Speaker of the House Paul Ryan, and Ways and Means Committee Chairman Kevin Brady—who had been meeting regularly, released a statement repeating their goals. They aimed to achieve increased economic growth through lower tax rates on businesses and individuals, a reform of international tax rules, greater fairness (principally through lower taxes on families), and, of course, less

1. Portions of this Part are adapted from a short article published in *The American Interest* before the 2017 legislation was enacted. Michael J. Graetz, *Heading off a Cliff?*, 13 AM. INTEREST (Jan./Feb. 2018), https://www.the-american-interest.com/2017/10/25/heading-off-cliff [https://perma.cc/JB6J-8P5Q].

2. *See The 1-Page White House Handout on Trump's Tax Proposal*, CNN (Apr. 26, 2017, 8:27 PM), https://www.cnn.com/2017/04/26/politics/white-house-donald-trump-tax-proposal/index.html [https://perma.cc/GR8H-BN82].

complexity.[3] Soon thereafter, forty-five of the forty-eight Senate Democrats sent Senator McConnell a letter containing their three principles for tax reform, two of which were that it neither "benefit the wealthiest individuals" nor "increase our budget deficit."[4] Senator McConnell rejected those constraints in a Kentucky minute.

Then, during the last week of August, Secretary Mnuchin announced that the Big Six had a "very detailed" tax reform plan.[5] Two weeks earlier, NEC Director Cohn had described it as a "skeleton" plan[6]—by which he surely meant to suggest that it needed some fleshing out, not that it had died and was awaiting burial. On September 14, Chairman Brady said that the tax plan—scheduled for release during the week of September 25—would not say exactly what the new business tax rate would be.[7] Later that same day, Secretary Mnuchin said the plan would announce the tax rate.[8] Meanwhile, President Trump said that the business rate would be 15%—which everyone knew was a figure lower by at least five percentage points than the tax rate actually would be.[9] So things seemed to be going about as smoothly as the Republican effort to "repeal and replace" the Affordable Care Act.

On September 27, the Big Six released their "Unified Framework for Fixing Our Broken Tax Code."[10] In its nine pages, they set forth a list of proposed changes. The proposals included a corporate tax rate of 20% and a special 25%

3. *See Joint Statement on Tax Reform*, U.S. DEP'T TREASURY (July 27, 2017), https://www.treasury.gov/press-center/press-releases/Pages/sm0134.aspx [https://perma.cc/U2C6-AYAF].

4. *Senate Democrats Lay Out Key Principles for Tax Reform*, ED MARKEY, U.S. SENATOR FOR MASS. (Aug. 1, 2017), https://www.markey.senate.gov/news/press-releases/senate-democrats-lay-out-key-principles-for-tax-reform [https://perma.cc/2XNE-ZGXG].

5. Jeff Cox, *Mnuchin: We Have a "Very Detailed" Tax Plan Ready*, CNBC (Aug. 31, 2017, 11:38 AM ET), https://www.cnbc.com/2017/08/31/mnuchin-we-have-a-very-detailed-tax-plan-ready.html [https://perma.cc/5JDC-AF33].

6. Evelyn Cheng, *White House Top Economic Advisor Cohn: We Worked on Tax Reform this "Morning" and It Can Happen this Year*, CNBC (Aug. 15, 2017, 5:57 PM ET), https://www.cnbc.com/2017/08/15/white-house-top-economic-advisor-cohn-we-worked-on-tax-reform-this-morning-and-it-can-happen-this-year.html [https://perma.cc/6QD4-897E].

7. Naomi Jagoda, *Mnuchin: Plan Is for No Tax Cut for the Rich*, HILL (Sept. 14, 2017, 5:46 PM), http://thehill.com/policy/finance/350761-mnuchin-plan-is-for-no-tax-cut-for-the-rich [https://perma.cc/M2F2-CDS2].

8. *Id.*

9. Saleha Mohsin & Justin Sink, *Trump Officials Temper Expectation of 15% Corporate Tax Rate*, BLOOMBERG (Sept. 12, 2017, 9:29 AM), https://www.bloomberg.com/news/articles/2017-09-12/mnuchin-says-tax-overhaul-may-be-backdated-to-start-of-the-year.

10. *Unified Framework for Fixing Our Broken Tax Code*, U.S. DEP'T OF TREASURY (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf [https://perma.cc/9JKS-LQC5] [hereinafter *Unified Framework*].

tax rate for partnerships and Subchapter S corporations.[11] They labeled the latter a special tax rate for small businesses—even though nearly two-thirds of the net income of partnerships is earned by the largest 1% of firms[12] (those with more than $50 million in assets[13]), and more than 70% of partnership and Subchapter S income ends up in the pockets of the top 1% of income earners.[14]

On the individual income tax side, the Sixers' framework was especially vague. It announced an "aim to consolidate the current seven tax brackets," which then ranged from 10% to 39.6%, "into three tax brackets of 12%, 25% and 35%."[15] But the framework failed to say at what levels of income these new rates would kick in. The framework also promised to double the standard deduction and replace personal exemptions with tax credits for children and other dependents.[16] One large New York law firm aptly told its clients that the Sixers had handed us a frame without a picture.[17]

Less than three months later, with no public hearings and input mostly from lobbyists, the full picture was completed. The far-reaching legislation signed by President Trump contained more than 500 pages of statutory amendments to the Internal Revenue Code. Unsurprisingly, the hurried process to move complex tax legislation, which included important provisions without precedent either here or abroad, through Congress without public input produced unintended consequences.

By comparison, the 1986 Tax Reform Act spent fifty-three weeks in the Congress. Two years before that, the Treasury had released more than 600 pages analyzing the various tax reform ideas that led to the landmark 1986 legislation, and in May 1985, President Ronald Reagan released nearly 500 pages detailing his proposals.[18] The crowning domestic-policy achievement of Reagan's presidency, the bipartisan 1986 tax reform legislation, was widely heralded as the

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11. *Id.* at 7.

12. *See Present Law and Data Related to the Taxation of Business Income*, JCX-42-17, JOINT COMMITTEE ON TAX'N 56 (Sept. 15, 2017), https://www.jct.gov/publications.html?func=startdown&id=5021 [https://perma.cc/S3YD-AGWW].

13. *See id*. at 50.

14. *See* INTERNAL REVENUE SERV., STATISTICS OF INCOME—INDIVIDUAL INCOME TAX RETURNS PUBLICATION 1304, tbl.1.4 (2015); *see also infra* Section IV.A.

15. *Unified Framework*, *supra* note 10.

16. *Id.*

17. *Tax Reform Frame Released—Picture Missing*, DEBEVOISE & PLIMPTON LLP (Sept. 28, 2017), https://www.debevoise.com/insights/publications/2017/09/Tax-Reform-Frame-Released-Picture-Missing.

18. *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, U.S. TREASURY DEPT. (May 29, 1985), https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Reform-Proposal-1985.pdf [https://perma.cc/2C32-YVVT].

most important tax legislation since the income tax was converted into a tax on the masses during World War II.[19]

A. Partisan Legislation

Despite longtime bipartisan support for a substantial reduction in the corporate tax rate, 2017 marked the first time in modern history that House and Senate Republicans enacted major tax legislation without any Democratic votes. President Trump signed the legislation on December 22, 2017, two days after dozens of Republican legislators had joined him at the White House to celebrate the Act's passage. Unsurprisingly, having been frozen out of any participation in shaping the legislation, Democrats howled. House Minority Leader Nancy Pelosi described the legislation as an "Armageddon"[20] and said that the tax overhaul had cast "a dark cloud" over the Capitol.[21] She complained that it gave millions in tax breaks to wealthy Americans and large corporations but only "crumbs" to middle and lower income citizens.[22] Even before President Trump signed the legislation, the Democratic Senatorial Campaign Committee revealed an advertisement claiming that the "Republican tax scheme gives huge tax breaks to corporations but raises taxes on middle class families."[23] Republicans responded that bonuses of $1,000 paid by some large corporations to their workers in response to the legislation were hardly crumbs; Vice President Mike Pence called them "Christmas."[24] Democrats planning to run for election in 2018 in moderate or conservative districts went out of their way to distance themselves from Pelosi's "crumbs" characterization.

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19. For an example of the press coverage of the 1986 Act, see David E. Rosenbaum, *The Tax Reform Act of 1986: How the Measure Came Together; A Tax Bill for the Textbooks*, N.Y. TIMES (Oct. 23, 1986), https://www.nytimes.com/1986/10/23/business/tax-reform-act-1986-measure-came-together-tax-bill-for-textbooks.html [https://perma.cc/8JKL-3CGY].

20. Mike Lillis, *Pelosi Denounces GOP Tax Reform as 'Armageddon,'* HILL (Dec. 4, 2017, 8:54 PM), http://thehill.com/homenews/house/363238-pelosi-denounces-gop-tax-reform-as-armageddon [https://perma.cc/NHU9-JQDK].

21. Bob Salsberg, *Pelosi: Tax Overhaul Has Cast a 'Dark Cloud' Over Washington*, REAL CLEAR POLITICS (Feb. 2, 2018), https://www.realclearpolitics.com/articles/2018/02/02/pelosi_tax_overhaul_has_cast_a_dark_cloud_over_washington_136179.html [https://perma.cc/4TR9-N99F].

22. Scott Wong, *Pence Rips Pelosi for Describing $1,000 as 'Crumbs,'* HILL (Jan. 31, 2018, 8:37 PM), http://thehill.com/homenews/house/371748-pence-rips-pelosi-for-describing-1000-as-crumbs [https://perma.cc/K8TM-SEMN].

23. Democratic Senatorial Campaign Committee, *The GOP Tax Scam in 6 Seconds*, YOUTUBE (Dec. 19, 2017), https://www.youtube.com/watch?v=9Le27K8kC2A.

24. *See* Wong, *supra* note 22.

The Democrats' complaints about the law's reduction in the corporate tax rate from 35% to 21% ring hollow. Democrats themselves had long realized that the U.S.'s exceptionally high corporate tax rate in today's global economy—with highly mobile capital and intellectual property income—invited both U.S. and foreign multinational companies to locate their deductions, especially for interest and royalties, in the United States, and to locate their income in low- or zero-tax countries. This is obviously not a recipe for economic success. Both before and after the legislation, Democrats urged a corporate tax rate of 25% to 28%;[25] meanwhile, Donald Trump asked for a 15% rate.[26] So, even if Democrats had been involved in the legislative process, the 21% rate that we ended up with would be in the realm of a reasonable compromise. Democrats, however, well understand that regardless of the *economic* disadvantages of a high corporate tax rate, railing against a low corporate tax rate has *political* advantages.

The important irony is that the worst tax economically[27] is the best tax politically. But regardless, a significantly lower corporate rate has been long overdue, and raising it would be a mistake. If Democrats are unhappy with the distributional consequence that a corporate tax cut will benefit high-income shareholders, the appropriate remedy––given the mobility of business capital, businesses' ability to shift mobile intellectual property and financial income to low-tax jurisdictions, and the challenges of intercompany transfer pricing––is to increase taxes at the shareholder level, not to increase corporate tax rates.

In his recent book, journalist Bob Woodward describes a conversation between President Trump and Gary Cohn suggesting that President Trump understands this. At one point, Trump said, "I'll take the personal top rate to 44 percent [from its level then of 39.6 percent] if I can get the corporate rate to 15

25. *See* Laura Davison, *Here's What May Happen to Your Taxes If Democrats Win the House*, BLOOMBERG (Aug. 23, 2018, 4:00 AM EDT), https://www.bloomberg.com/news/articles/2018-08-23/overhauling-the-tax-overhaul-here-s-what-democrats-are-planning [https://perma.cc/QD9T-E4AN]. President Obama proposed a 28% corporate tax rate. Zachary A. Goldfarb, *Obama Proposes Lowering Corporate Tax Rate to 28 Percent*, WASH. POST (Feb. 22, 2012), https://www.washingtonpost.com/business/economy/obama-to-propose-lowering-corporate-tax-rate-to-28-percent/2012/02/22/gIQA1sjdSR_story.html?utm_term=.92be15b4f8f6 [https://perma.cc/YW6J-RJCH].

26. *See* Ben White & Nancy Cook, *Trump Still Pushing for a 15 Percent Corporate Tax Rate*, POLITICO (Sept. 5, 2017, 8:30 PM EDT), https://www.politico.com/story/2017/09/05/trump-corporate-tax-rate-cut-242354 [https://perma.cc/FH7J-SCEX].

27. *See, e.g.*, *Tax and Economic Growth,* Org. for Econ. Co-operation & Dev. (Econ. Dep't Working Paper No. 620, 2008), http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=eco/wkp(2008)28 [https://perma.cc/T5FQ-X6CC] (showing that in a tax and growth model, the corporate tax is the most distortive). For a discussion of some of the economic inefficiencies of the corporate tax, see ALVIN C. WARREN, JR., INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION 21-38 (AM. LAW INST. 1993).

percent." "Sir," Cohn responded, "you can't take the top rate up. You just can't." When Trump asked why not, Cohn explained, "You're a Republican."[28] That was a trade-off that might have picked up some Democratic votes, but surely not enough to compensate for the Republican votes it would have lost.

On the other hand, Democratic governors in the Northeast and on the West Coast and Democrats in Congress do have a legitimate complaint. They argue that the new $10,000 limitation on the deduction for state and local property and income taxes would not have been enacted had Democrats participated in the enactment of this legislation. There is no doubt that the revenue from this provision will come predominately from taxpayers who reside or work in high-tax "blue" states. In response, several of these states have explored ways to avoid the impact of this limitation. Three states—New York, New Jersey and Connecticut––filed a longshot lawsuit in federal court challenging the constitutionality of the change on the grounds that it interferes with the states' rights to make their own fiscal decisions, and that it unfairly targets a handful of Democratic states.[29] In August 2018, the Treasury Department issued proposed regulations intended to block the ability of the states to elude the limitation.[30]

It will be interesting in a year or so to see what the American people think of this legislation. It seems quite likely that by the spring of 2019, when people are filing their tax returns, many people who are used to getting refunds of over-withheld taxes will find themselves facing significant tax bills––especially in high-tax states and localities where people have not adequately adjusted their withholding to reflect the deductions they have lost. Given the differences in the

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28. Bob Woodward, Fear: Trump in the White House 290 (2018).

29. *See Preliminary Report on the Federal Tax Cuts and Jobs Act*, N.Y. State Dep't Tax'n & Fin. (Jan. 2018), https://www.tax.ny.gov/pdf/stats/stat_pit/pit/preliminary-report-tcja-2017.pdf [https://perma.cc/98AP-UZKD]; Joseph Spector, *New York, New Jersey and Connecticut to Sue Over Federal Tax Law*, USA Today (Jan. 26, 2018, 11:04 AM), https://www.usatoday.com/story/money/nation-now/2018/01/26/ny-nj-conn-sue-over-federal-tax-law/1068862001 [https://perma.cc/EB3F-FW2D].

30. A few high-tax states are restructuring their tax laws in an effort to allow residents to effectively retain deductions eliminated by the 2017 legislation. For a discussion of the states' efforts, see Joseph Bankman et al., *State Responses to Federal Tax Reform: Charitable Tax Credits*, 159 Tax Notes 641 (2018). The Internal Revenue Service announced that it would issue regulations to limit such efforts. *Guidance on Certain Payments Made in Exchange for State and Local Tax Credits, Notice 2018-54*, Internal Revenue Serv. (2018), https://www.irs.gov/pub/irs-drop/n-18-54.pdf [https://perma.cc/X4RC-3M7F]. And it subsequently proposed such regulations. Contributions in Exchange for State or Local Tax Credits, 83 Fed. Reg. 43563 (Aug. 27, 2018). At least one estate planner is attempting to avoid the new limitations on property tax deductions by using non-grantor trusts. *See* Linley Browning, *How the Rich Can Dodge Trump's Property Tax Hike*, Bloomberg (June 15, 2018, 4:00 AM), https://www.bloomberg.com/news/articles/2018-06-15/rich-looking-to-dodge-property-tax-caps-turn-to-alaskan-trusts.

tax rules that now apply to independent contractors and employees and to different kinds and organizations of businesses,[31] there will also likely be much controversy stirred up in country clubs and along the sidelines of children's athletic endeavors as some people brag about unexpected tax windfalls, and their compatriots bemoan their failures to qualify.[32]

Soon after the enactment in 2010 of the Patient Protection and Affordable Care Act, better known as Obamacare, Republicans started calling for legislation to "repeal and replace" it, an effort that failed in 2017 even though Republicans controlled the White House and both the House and the Senate. Given the 2017 tax act's combination of tax cuts for high income individuals, the major reduction of the corporate tax rate, and the doubling of the estate tax exemption (to $22 million for a married couple), we will certainly hear from Democrats in the 2018 and 2020 campaigns about the need to "repeal and replace" the 2017 tax legislation. And repealing and replacing tax legislation is considerably easier than repairing the nation's health insurance system. This partisan tax legislation ushered in instability along with the new tax law.

II. A MASSIVE INCREASE IN THE FEDERAL DEBT

No doubt analysts can find provisions to praise and others to lament in this expansive legislation, but we should not overlook its most important shortcoming: its effect on federal deficits and debt. Pundits and politicians like to compare the 2017 legislation to the Tax Reform Act of 1986, calling it the most important tax revision in a generation. Unfortunately, given our country's ongoing deficits and the size of its federal debt, the 2017 tax legislation resembles the 1981 or 2001 tax cuts more than the 1986 reform.

The 2017 legislation is a far cry from the 1986 Tax Reform Act. That legislation was not only revenue neutral, but also made income taxation far more equal regardless of the income's source. The 1986 reform also significantly reduced the

31. For a further discussion of this point, see *infra* Section IV.B.

32. For a description of some of these distinctions, see, for example, Jim Tankersley, *Who Gets a New 20% Tax Break? The Treasury Dept. Speaks, and Trump May Save*, N.Y. TIMES (Aug. 8, 2018), https://www.nytimes.com/2018/08/08/us/politics/tax-deduction-pass-through-businesses.html [https://perma.cc/R8T4-K5HT].

number and size of federal tax expenditures.[33] In contrast, tax expenditures increased from 2017 to 2018 because of the 2017 legislation.[34]

In 2017, as they had in 2001, Congress and the White House went to extraordinary lengths to disguise the size of the tax reductions they enacted. The 2017 budget resolution required tax cuts not to exceed $1.5 trillion over ten years in order to be enacted through "reconciliation," a procedure that allows tax legislation to pass the Senate with only fifty-one votes. But, as with President George W. Bush's tax cuts in 2001, Congress in 2017 enacted phase-ins of tax increases and sunsets of tax cuts that combine to dramatically understate the tax bill's actual revenue costs. When the 2001 Bush tax cuts were enacted, moderate Democrats in the Senate achieved a "victory" by reducing the cuts' projected costs over a ten-year period from $1.6 trillion to $1.3 trillion. But the bill was festooned with so many phase-ins and phase-outs that the actual cost over the past 15 years has been far closer to $3 trillion than to $1.3 trillion.[35]

We have never in modern times faced such a dangerous imbalance between the levels of federal spending and revenues. At more than 75% of GDP, the federal debt owed to the public is now greater as a percentage of U.S. economic output than it has been at any time since the end of World War II.[36] And back then our country's economic condition and prospects were great: Europe and Japan were recovering from the devastation of the war, and China was entering into a dark communist era. No matter how bad our tax system may have been, our economy was poised to grow for decades at an unprecedented pace. And the United States government then owed 98% of the money it had borrowed to finance the war to Americans. Now our national debt is rapidly heading towards

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33. *See* Allison Rogers & Eric Toder, *Trends in Tax Expenditures, 1985-2016*, URBAN INST. & BROOKINGS INST. TAX POL'Y CTR. (Sept. 16, 2011), https://www.urban.org/sites/default/files/publication/27561/412404-Trends-in-Tax-Expenditures---.PDF [https://perma.cc/26C2-2KTM].

34. *Estimates of Federal Tax Expenditures for Fiscal Years 2017-2021, JCX-34-18*, JOINT COMMITTEE ON TAX'N, (2018), https://www.jct.gov/publications.html?func=startdown&id=5095 [https://perma.cc/GG9J-C33K].

35. For estimates, see William G. Gale and Peter Orzag, *Tax Policy in the Bush Administration, Revenue and Budget Effects,* 145 TAX NOTES 105, 106 (Oct. 4, 2004); Glenn Kessler, *Revisiting the Cost of the Bush Tax Cuts*, WASH. POST. (May 10, 2011), https://www.washingtonpost.com/blogs/fact-checker/post/revisiting-the-cost-of-the-bush-tax-cuts/2011/05/09/AFxTFtbG_blog.html?noredirect=on&utm_term=.09d870d5e317 [https://perma.cc/WGH5-Y76A]; Chye-Ching Huang, *Budget Deal Makes Permanent 82 Percent of President Bush's Tax Cuts*, CTR. ON BUDGET & POL'Y PRIORITIES 1 (Jan. 3, 2013), https://www.cbpp.org/sites/default/files/atoms/files/1-3-13tax.pdf [https://perma.cc/CAH5-5AYM].

36. CONG. BUDGET OFF., THE BUDGET AND ECONOMIC OUTLOOK: 2018 TO 2028, at 1, 5 (Apr. 2018) [hereinafter BUDGET AND ECONOMIC OUTLOOK], https://www.cbo.gov/system/files?file=115th-congress-2017-2018/reports/53651-outlook.pdf [https://perma.cc/MEL6-H47R].

$20 trillion, with more than 40% owed to foreigners, some of whom we cannot rely on to be our friends.[37]

At a 5% interest rate, interest on the federal debt alone will cost more than $1 trillion a year.[38] If we fail to get control of the federal budget, rising interest costs will devour an ever-larger share of the federal budget. Public debt growing to such levels will also generate new challenges to the dollar's role as the world's reserve currency. The growing national debt thus increases the risks of substantially higher interest rates, inflation, and even another financial crisis. Over time, the debt may threaten the living standards of the American people. And given the size of the federal debt, the promises that have been made to the retiring Baby Boom generation for retirement income and health insurance coverage, and the costs of a seemingly endless War on Terror, we simply cannot afford the 2017 tax cuts.

The major tax policy challenge of the twenty-first century is the need to address the nation's fiscal condition fairly and in a manner conducive to economic growth. But ever since California adopted Proposition 13 nearly forty years ago, antipathy to taxes has served as the glue that has held the Republican coalition together.[39] Even though U.S. taxes as a percentage of our economy are low by OECD standards,[40] and low by our own historical experience, anti-tax attitudes have become ever more important for Republicans politically. So, revenue-positive, or even revenue-neutral, tax reform—at least while the GOP maintains its legislative majority—is politically impossible.

Here is what the 2017 legislation portends: first, the sunsets of the individual tax cuts at the end of 2025 will cost an additional $600 billion if extended to 2028. Second, an extension of business provisions scheduled to expire between 2019 and the end of 2025 will cost an additional $400 billion. Third, the extension of other tax provisions currently in place but set to expire between 2018 and 2022 will cost $450 billion more. In combination, extending these provisions—

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37. *See id.* at 86.

38. *See* Peter J. Tanous, *Rising Interest Rates Will Be Devastating to the US Economy for One Big Reason*, CNBC (Mar. 6, 2018, 6:00 PM), https://www.cnbc.com/2018/03/05/rising-interest-rates-will-be-devastating-to-the-us-economy-for-one-big-reason.html [https://perma.cc/4EHS-RZM2].

39. For discussion of the anti-tax movement and opposition to taxes as the glue that has held the Republican coalition together, see generally, MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH (2005).

40. *See Revenue Statistics - OECD Countries: Comparative Tables*, ORG. ECON. CO-OPERATION & DEV., https://stats.oecd.org/Index.aspx?DataSetCode=REV# [https://perma.cc/LJX2-ABB3].

which seems very likely—would double the ten-year cost of the 2017 Act from $1.5 trillion to nearly $3 trillion.[41]

Under the 2017 tax law, the federal debt held by the public is estimated to rise to more than 96% of GDP by 2028,[42] and this does not count the omnibus spending bill signed in 2018 by President Trump. If current tax policy remains in place, the federal debt then will be about 105% of GDP,[43] and if current spending levels are also maintained, the debt will be more than 106% of GDP.[44] By 2048, under these assumptions, federal debt will exceed 200% of GDP.[45] Servicing interest on that debt will become the largest federal spending program by 2050.[46]

Under current law, the deficits for the coming ten years are estimated to total $12.4 trillion—with deficits greater than $1 trillion expected for every year beginning in 2020.[47] If the current policy levels of taxes and spending are maintained, total deficits over the next decade will approach $16 trillion, with deficits greater than 5% of GDP beginning in 2020.[48] By 2028, current fiscal policy will produce deficits of more than 7% of GDP annually.[49] This is unsustainable.

Although different economists have—unsurprisingly—reached differing judgments about the macroeconomic effects of the 2017 legislation, no realistic estimate suggests that the boost in economic growth due to those key changes will affect the projected increases in the national debt.[50]

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41. *See* BUDGET AND ECONOMIC OUTLOOK, *supra* note 36, at 89. Note also that the estimates in this section follow different methodologies. The first takes current law as written, including sunsets of tax breaks. The second assumes that current policy will remain in place and the sunsets scheduled to take place in the future will not occur (i.e., Congress will extend tax breaks before they expire).

42. *Id.* at 5.

43. *Id.* at 6.

44. Alan J. Auerbach et al., *The Federal Budget Outlook: Even Crazier After All These Years*, URBAN INST. & BROOKINGS INST. TAX POL'Y CTR. 1 (Apr. 23, 2018), https://www.brookings.edu/wp-content/uploads/2018/04/es_20180423_budgetoutlook.pdf [https://perma.cc/RN6G-9CDM].

45. *CBO's 2018 Long-Term Budget Outlook*, COMMITTEE FOR RESPONSIBLE FED. BUDGET 2 (June 26, 2018), http://www.crfb.org/sites/default/files/2018_Long_Term_Budget_Outlook.pdf [https://perma.cc/6UWQ-PUJL].

46. *Id.* at 3.

47. *See* BUDGET AND ECONOMIC OUTLOOK, *supra* note 36.

48. *See* Auerbach et al., *supra* note 44, at 12 fig.1.

49. *Id.* at 4.

50. Harvard economists Robert Barro and Jason Furman have estimated that for 2020 to 2027, the predicted impact of the 2017 legislation on GDP growth is 0.0 to 0.1 percentage points per year. Robert J. Barro & Jason Furman, *The Macroeconomic Effects of the 2017 Tax Reform* 57 (Brookings Papers on Econ. Activity, Conference Drafts, 2018), https://www.brookings.edu

Republican deficit hawks—such as retiring Senator Bob Corker of Tennessee, who once insisted that he would not vote for any tax legislation if it "added one penny to the deficit"—became hummingbirds when the tax cut legislation came up for a vote. Senator Corker later confessed, "If [the tax bill] ends up costing what has been laid out [by the Congressional Budget Office (CBO) report], it could well be one of the worst votes I've made."[51]

President Trump and Congressional Republicans have talked about enacting a second major tax bill in 2018, but this is just political kabuki theater. The Republicans wanted to force the Democrats to vote against extending middle income tax cuts before the 2018 midterms. After the House voted to extend the individual tax cuts on September 28, 2018. Massachusetts Congressman and Ranking Ways and Means Committee Democrat Richard Neal said that the bill would "further compromise the future of Medicare and Social Security," adding that it demonstrates that Republicans are hardly the party of fiscal rectitude or conservatism."[52]

III. INTERNATIONAL TAX CHALLENGES

Congress's greatest challenge in crafting this tax legislation was figuring out what to do about the international tax rules. The United States is not unique in this regard: how to tax international income of multinational corporations is the most difficult tax policy issue for 018, countries around the world.

It has been clear for a long time that the system of taxing international income that served the United States rather well for nearly a century had broken down.[53] The combination of an exceptionally high U.S. corporate tax rate and corporate tax planners' creative ability to shift capital and intellectual-property

/wp-content/uploads/2018/03/4_barrofurman.pdf [https://perma.cc/4T2U-LW6M]. The Joint Committee on Taxation, which used a weighted average of three macroeconomic models, reached a similar conclusion. *Id.* at 57-58; *see also* William G. Gale et al., *Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis*, URBAN INST. & BROOKINGS INST. TAX POL'Y CTR. (June 13, 2018), https://www.brookings.edu/wp-content/uploads/2018/06/ES_20180608_tcja_summary_paper_final.pdf [https://perma.cc/8ACP-MYAQ].

51. Niv Elis, *Corker: Tax Cuts Could Be 'One of the Worst Votes I've Made'*, HILL (Apr. 11, 2018, 12:10 PM EDT), http://thehill.com/policy/finance/382663-corker-tax-cuts-could-be-one-of-worst-votes-ive-made [https://perma.cc/5S4W-JELT].

52. Naomi Jagoda, *House Votes to Extend Individual Tax Cuts*, HILL (Sept. 28, 2018, 12:12 PM EDT), https://thehill.com/business-a-lobbying/408924-house-votes-to-extend-individual-tax-cuts [https://perma.cc/7XH9-LCNL].

53. One example of this breakdown is the practice of corporate inversions and the government efforts to stop it. *See, e.g.*, Katherine M. Hetherington & Brian M. Sholley, *Anti-Inversion Regulations and Legislation Fail to Prevent the Exodus of U.S. Companies Abroad*, 93 TAXES 23, 23 (2015).

income to low tax countries had resulted in $2.5 to $3 trillion of assets of U.S. multinationals that could only be re-invested abroad without incurring a substantial tax.[54] Other countries, including the United Kingdom and Japan, had already abandoned similar rules.

But in creating a new regime for international income taxation, Congress faced major dilemmas. At the conceptual level, the normative underpinnings of the international tax system were broken: the idea of continuing to "compromise" between capital export neutrality and capital import neutrality[55] offered no guidance to policymakers, and instead had simply become an invitation for political mischief.[56] The OECD's "base erosion and profit sharing" (BEPS) project initiated by the G20 in 2012, along with subsequent actions by the European Commission and unilateral changes by some countries, had made clear that foreign countries were focused on strengthening their ability to tax activities by U.S. multinationals in their countries. Meanwhile, the United States continued to insist that those revenues rightfully belonged to it. The lead U.S. Treasury negotiator, Robert Stack, captured the difficulties well in June 2015 when he told an OECD conference audience that when he was negotiating at the OECD, he had the feeling that all the other states wanted the United States to pay for everyone's drinks.[57] He added that the United States was "extremely disappointed in the output and our collective failure . . . to do more and better work than we've done."[58]

The conceptual difficulties of taxing international income, including the ambiguous and malleable nature of both "source" and "residence" as foundational building blocks, have, of course, been compounded by multinational corporations' ability to shift the character and location of capital income through innovative financial instruments and to move intellectual property income through ownership and contractual arrangements to low- or zero-tax jurisdictions, as

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54. The Joint Committee on Taxation estimated this amount to be $2.6 trillion in 2015. *See* Letter from Hon. Kevin Brady to Hon. Richard Neal (Aug. 31, 2016), http://waysandmeans.house.gov/wp-content/uploads/2016/09/20160831-Barthold-Letter-to-BradyNeal.pdf [https://perma.cc/25G9-8PZ7]; *see also* Nick Wells, *Companies are Holding a $2.6 Trillion Pile of Cash Overseas That's Still Growing*, CNBC (Apr. 28, 2017), https://www.cnbc.com/2017/04/28/companies-are-holding-trillions-in-cash-overseas.html [https://perma.cc/52Z8-XJBX].

55. Capital export neutrality requires the same tax treatment for investors whether they invest at home or abroad. Capital import neutrality requires the same tax treatment for both domestic and foreign investors. It is now widely understood that both principles can hold simultaneously only when all countries have the same income tax systems, including identical tax rates and bases and the same rules about source and resident taxation. MICHAEL J. GRAETZ, FOLLOW THE MONEY: ESSAYS ON INTERNATIONAL TAXATION 58-59 (2016).

56. *See, e.g.*, *id.* at 93-125.

57. *Id.* at 275.

58. *Id.* at 465 n.9.

well as by their ability to arbitrage differences in national legal regimes to avoid taxes.[59] At the same time, governments have held fast to arm's-length intercompany transfer pricing fictions that they cannot enforce. Countries have also engaged in aggressive tax competition, bidding down taxes to secure the location of research and development (R&D), jobs, capital flows, and investments.[60]

Congress confronted daunting challenges when deciding what rules would replace our failed foreign-tax-credit-with-deferral regime. There were essentially two options: (1) strengthen the source-base taxation of U.S. business activities and allow foreign business earnings of U.S. multinationals to go untaxed; or (2) tax the worldwide business income of U.S. multinationals on a current basis when earned with a credit for all or part of the foreign income taxes imposed on that income. Faced with the choice between these two very different regimes for taxing the foreign income of the U.S. multinationals, Congress chose both.

The details of this aspect of the legislation are complex, but here is a quick summary: first, the United States has a territorial system of taxation that exempts the foreign business income of foreign corporate entities that are owned between 10% and 50% by U.S. shareholders[61] and similarly exempts income of up to 10% of the adjusted basis from plant and equipment abroad for foreign subsidiaries that are more than 50% owned by U.S. shareholders.[62] Second, a 10.5% tax rate (scheduled to rise to 13.175%) is imposed on the current income of a foreign subsidiary on income in excess of the 10% amount, with a credit for up to 80% of the foreign taxes paid on this income, the "Global Intangible Low-Taxed Income" (GILTI).[63] The Code also includes a special lower rate on export income of U.S. goods and services,[64] along with a minimum source-based tax that depends on base-eroding payments to foreign related companies, the "Base Erosion and Anti-Abuse Tax" (BEAT).[65]

Congress therefore eliminated the tax burden of prior law that a company incurred when it repatriated foreign profits taxed at a foreign rate lower than the U.S. rate to the United States, allowing companies to move cash back to the United States without a residual U.S. tax. This simultaneously eliminated the distortive accounting rules that turned on whether the earnings were considered

59. *Id.* at 155-221.

60. *Id.* at 262-63.

61. I.R.C. § 245A (2018).

62. *Id.* § 951A.

63. *Id.*

64. *Id.* § 250.

65. *Id.* § 59A.

"permanently reinvested abroad."[66] Congress also imposed a one-time transition tax on the more than $2.5 trillion in unrepatriated earnings held offshore by U.S. multinationals—at a 15.5% rate on cash or cash equivalents and 8% on other assets.[67] Even though the transition tax rates were higher than many U.S. multinationals had anticipated, knowledge that the tax was coming allowed for much anticipatory tax planning, and based on its review of financial statements, *Bloomberg* has estimated that the tax will likely raise less than half of the $339 billion estimated by the Joint Committee on Taxation.[68] Nevertheless, this provision means that the post-1986 earnings of U.S. multinationals, which had been labeled by many as "nowhere" or "stateless" income, has now, in fact, been taxed by the United States, albeit at a low rate.

The special low tax rate for "deemed intangible income" on sales and services sold, leased, or performed outside the United States seems to be a complex U.S. variation on patent boxes common elsewhere, but without the requirement of the OECD BEPS rules that the related R&D be performed in the United States.[69] In addition to other problems, this provision almost certainly violates the WTO agreements against export subsidies and seems likely to be changed in the years ahead—although it is far from clear that mimicking the patent boxes used in Europe and elsewhere would be a substantial improvement.[70]

Despite earlier proposals by both former President Obama and the Republican House Ways and Means Committee Chairman Dave Camp of Michigan, the U.S. business community apparently believed that it could avoid any minimum tax on its income abroad in a Republican tax bill. Instead, it got two minimum tax type provisions—the GILTI and the BEAT—both of which reflect Congress's disbelief that transfer pricing rules will now work for intellectual property income. Cars often seem to work reasonably well when built on a truck chassis, but the GILTI seems to be more like a truck built on a car chassis. By tacking this minimum tax onto the rules of Subpart F and defining its scope by an excess of the rate of return earned on tangible property abroad, Congress has, presumably

66. *APB 23: Accounting for Income Taxes—Special Areas*, FIN. ACCT. FOUND. (Apr. 1972), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220340119& [https://perma.cc/ZWN9-JYTK].

67. I.R.C. § 965.

68. *See* David Morgan, *U.S. Treasury Proposes Rules on Repatriating Overseas Corporate Income*, REUTERS (Aug. 1, 2018, 12:47 PM), https://www.reuters.com/article/us-usa-tax-repatriation/u-s-treasury-proposes-rules-on-repatriating-overseas-corporate-income-idUSKBN1KM5MA [https://perma.cc/MB2K-Y3NW] (offering the $339 billion figure).

69. I.R.C. § 250.

70. GRAETZ, *supra* note 55, at 155-221.

inadvertently, created some incentives for locating plant and equipment abroad and has no doubt raised new tax-planning issues for supply chains abroad.[71]

With the GILTI in place to address outbound base erosion, Congress ostensibly enacted the BEAT to address inbound base erosion. Applicable only to companies with at least $500 million of annual gross receipts and a threshold of deductible payments to foreign-related parties by either U.S. or foreign multinational corporations, the provision imposes a tax of 10% on these payments, scheduled to rise to 12.5% in 2026.[72] The BEAT was an unanticipated provision, which was not vetted before its enactment. It is, frankly, a bit of a mess. For example, it was intended to stop base erosion through royalty payments. But it misses the mark almost completely for goods through an exemption for costs of goods sold which may have imbedded royalties. In contrast, it overshoots the mark by taxing many payments for services that are at arm's length and not tax-motivated.[73] It also ignores any foreign taxes imposed on the payments subject to it.[74] Again, this hardly seems a stable provision.

Congress adopted the now widespread limitation of 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) on net business interest expense deductions—a provision that has relatively small bite—but it is worth noting that the limitation is scheduled to shift to 30% of EBIT in the future and, if that happens, the restriction will become more significant.[75]

Even this brief glimpse into the complexities of our new international income tax regime makes clear that we do not now have a stable set of international tax rules. Because of the unusual and hurried process for enacting these rules, many problems have emerged that cannot be fixed by Treasury regulations. For example, by tacking the GILTI on to subpart F, rather than adopting it as a standalone minimum tax, Congress created a host of problems and new tax planning opportunities for utilizing foreign tax credits. The BEAT, in contrast, will inad-

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71. *See* Martin A. Sullivan, *Economic Analysis: More Than Technical Corrections and Regulations Needed to Fix GILTI*, 159 TAX NOTES 939 (2018) (offering a detailed summary of the new international tax provisions); *see also e.g.*, Stewart R. Lipeles et al., *Foreign Tax Credit Planning: The Potential Benefits of Subpart F Income*, 96 TAXES MAG. 5 (Sept. 2018); Daniel N. Shaviro, *The New Non-Territorial U.S. International Tax System, Part 2*, 160 TAX NOTES 171, 171-94 (2018); Moshe Spinowitz, *Tax Efficient Supply Chain in Shadow of Tax Reform*, 70 TAX EXECUTIVE 20 (2018) (describing potential tax-planning issues for international supply chains).

72. I.R.C. § 59A .

73. *See, e.g.*, Martin A. Sullivan, *Economic Analysis: 10 Reasons Congress Should Revisit the BEAT*, 159 TAX NOTES 1701 (2018); Thomas Zollo et al., *U.S. Tax Reform Considerations for Multinational Services Companies*, 90 TAX NOTES 627 (2018).

74. Sullivan, *supra* note 73.

75. I.R.C. § 163(j).

vertently often impose both U.S. and foreign taxes on the same amounts of income without any of the relief from such double taxation routinely granted by U.S. and OECD bilateral tax treaties. Fixing such matters through the kind of technical corrections legislation that often follows soon after major tax changes of this sort is less likely because of the partisan way the 2017 legislation was enacted.

The basic rules of international income taxation were formulated between 1918 and 1928 through a combination of unilateral and multilateral developments.[76] Now, a century later, the United States, the European Union, and the OECD have embarked, at times independently and at times together, on major efforts to rethink and revise these rules and treaties. The changes made by the 2017 legislation in the United States will inevitably play an important role as that endeavor unfolds.[77] Just to take one example, the GILTI may well serve as a model for future OECD efforts to impose a minimum level of tax on the international income of resident multinational companies.

IV. DOMESTIC TAX CHANGES

Fashioning domestic tax policy is—in principle, at least—much easier than addressing international income taxation. Analysts routinely evaluate domestic tax policy by asking two questions about equity: Are people similarly situated treated similarly, and is the burden of taxes distributed fairly? They also ask about efficiency: do tax rules inefficiently skew the allocation of resources or unduly inhibit economic growth? Some, no doubt, treat simplicity—the impact of the tax on administrative and compliance costs—as just one component of efficiency and others treat it as a separate norm, but everyone, including Members of Congress, pays at least lip service to the goal of a simpler tax system. Let me describe three important domestic aspects of the legislation so that readers may judge how Congress did.

A. Pass-Through Business Income

Representatives of partnerships, large and small, insisted that, given the reduction in the corporate tax rate, the rates of tax on their income—which is taxed only to the owners and not at the entity level—should also be reduced. Note that there is not a strict equivalence here: income from corporations is taxed twice,

76. GRAETZ, *supra* note 55, at 2-60.

77. *See, e.g.*, Allison Christians et al., *Foreword: International Tax Policy in a Disruptive Environment*, 72 BULL. INT'L TAX'N 191 (2018); Mindy Herzfeld, *News Analysis: A Post-Truth Tax World*, 90 TAX NOTES INT'L 1369 (2018).

once at the corporate level and again at the shareholder level. When corporations immediately distribute earnings, the effective total rate on the earnings is approximately equal to the top marginal rate on ordinary income, after the reduction in the corporate rate.[78] The tax benefit of the corporate form to shareholders is that undistributed earnings compound at the reduced corporate tax rate. With pass-through entities, however, all earnings are treated as distributed and subject to the favorable rates. One way to make the system more equitable would be to apply any special pass-through rate only to income that is reinvested in the pass-through entity.[79]

Business tax rate relationships have long played a significant role in the way businesses are organized. Before 1987, when corporate rates were lower than individual rates, there were more taxable corporations than partnerships and Subchapter S corporations combined. After the 1986 Act reversed the rate relationships, the number of flow-through entities more than tripled, and in recent years the vast majority of non-farm business tax returns have been filed by sole proprietorships, partnerships, limited liability companies, and Subchapter S corporations.[80] Most of these filers are small businesses, but the advent and growth of private equity, sovereign wealth funds, and business investments by university endowments, pension funds, and other tax-exempt entities, have allowed business entities to amass very large amounts of capital while avoiding public capital markets and, thereby, avoiding the corporate income tax. Even though most net business income in the United States is earned by large taxable corporations, nearly 45% of business income is now earned by flow-through business entities, including many that are very large.[81]

The 2017 legislation added a unique and unprecedented 20% deduction from taxable income for certain qualified business income, a rule that has the effect of

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78. The following example illustrates this equivalence: A corporation with $100 in pre-tax earnings per share will pay $21 in corporate income tax at the 21% rate. If the corporation distributes the remaining $79 per share to shareholders as a dividend, shareholders in the top income bracket will pay $15.80 (20%), leaving them with $63.20 after tax. If the taxpayer instead earned $100 of ordinary income, she would owe $37 in tax at the top rate, leaving her with $63.

Compare the two scenarios above to $100 of qualified business income. That taxpayer will deduct $20 and pay tax of $29.60 (37% on $80 of taxable income), leaving the taxpayer with after-tax income of $70.40.

79. For a discussion of the advantages of pass-through entities relative to corporations, see Daniel Halperin, *Choice of Entity – A Conceptual Approach*, 159 TAX NOTES 1601, 1601-02, 1604-05 (2018).

80. *See* JOINT COMMITTEE ON TAX'N, *supra* note 12, at 56; *SOI Tax Stats - Integrated Business Data*, INTERNAL REVENUE SERV. tbl. 1, https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data https://perma.cc/T3U7-XYFV] (last updated Sept. 18, 2018).

81. *Id.*

reducing the tax rates of most partnerships, Subchapter S corporations, and sole proprietorships by 20%.[82] For example, it reduces the tax rate on qualified income from 10% to 8% at the lowest bracket and from 37% to 29.6% at the top.

The new law creates important new differences in tax rates between employees and sole proprietorships—including individual independent contractors—and among businesses depending on their levels of income, their kinds of business, and, for higher income businesses, the wages they pay and the size of their business assets.[83]

Never before 2018 have such sharp distinctions in tax rates been applied so broadly to varying industries and lines of business. Congress justified this change as: (1) encouraging the growth of all non-corporate businesses, including those owned by lower-income taxpayers; (2) encouraging job creation and capital investment by noncorporate businesses, except for a specified group of service businesses owned by higher-income taxpayers; and (3) reducing the incentive for noncorporate businesses to switch to corporate status to qualify for the 21% rate.[84]

The new law denies the special 20% deduction to certain "specified service businesses" owned by upper-income taxpayers, including the performance of services in the fields of health, law, accounting, actuarial science, the performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, and securities trading or dealing.[85] But architects, engineers, and barbers are all eligible for the lower tax rate. My very successful naturopathic physician is clearly in the healthcare business and is accordingly disqualified, but I am unsure about my equally successful personal trainer. In proposed regulations issued in August 2018, the Treasury confirmed that doctors and dentists do not qualify for the reduced rates, but indicated that "owners of health spas may because they do not directly provide medical services."[86] Somehow the Treasury also concluded that banks that only make loans and take deposits are not financial institutions excluded from this tax benefit by the statute.[87] Further, because this law conditions its eligibility above an income threshold on the amount of wages, my barber will want all of the hair stylists in

82. I.R.C. § 199A(a) (2018).

83. *See, e.g.*, David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. (forthcoming 2018), https://ssrn.com/abstract=3089423; MICHAEL J. GRAETZ ET AL., FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 535-542 (8th ed. 2018).

84. *See* Halperin, *supra* note 79.

85. I.R.C. § 199A(d)(2)(A) (referencing § 1202(e)(3)(A)).

86. *See* Tankersley, *supra* note 32.

87. *Id.*

his salon to be his employees, but the stylists will want to be independent contractors to become eligible for the 20% rate cut, since employees do not qualify for this benefit.

Why did Congress lower the tax rate on barbers and tailors but not doctors, lawyers, actors, and athletes? Is having more hair stylists more beneficial to society than having more doctors? And are hair stylists who own their own business or operate as independent contractors more beneficial to society than hair stylists who are employees?

Although this tax break is supposed to benefit small business, many enormous businesses clearly qualify for the 20% deduction. For example, the construction and civil engineering firm Bechtel, reportedly the eighth-largest privately-owned U.S. company in 2017,[88] is organized as an S corporation and thus its owners will qualify for the reduced tax rate.[89]

Is it sensible policy to allow very large, privately-owned businesses to choose whether to be taxed as a pass-through entity or as a taxable corporation?

B. Employee Business Expenses

Next, let us look very briefly at the new rules on deductions for business expenses. Employees now cannot deduct business expenses that are not reimbursed by their employer,[90] but "independent contractors" are treated as business owners and—in addition to the 20% lower tax rate—they can deduct all their business expenses, even if they take the standard deduction.[91]

Whether one is an independent contractor or an employee is, however, not necessarily straightforward. For example, due to an accident of history a generation ago, UPS drivers are treated as employees, while FedEx drivers, at least until recently, were independent contractors.[92]

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88. *See #8 Bechtel*, FORBES, https://www.forbes.com/companies/bechtel [https://perma.cc/PN3Y-VRS3].

89. *See* Pat Garofalo, *Are the 'Small Businesses' Republicans Claim to Be Protecting from a Tax Increase Really Small?*, THINKPROGRESS (Sept. 13, 2010, 6:10 PM), https://thinkprogress.org/are-the-small-businesses-republicans-claim-to-be-protecting-from-a-tax-increase-really-small-cf21b0be339e [https://perma.cc/3LFQ-LQZM].

90. I.R.C. § 67(g).

91. *Id.* § 162.

92. *See* United Parcel Service, Inc., Annual Report for the Fiscal Year Ended December 31, 2017 (Form 10-K), at 5 (Feb. 21, 2018), https://www.sec.gov/Archives/edgar/data/1090727/000109072718000009/ups-12312017x10k.htm [https://perma.cc/2QVN-TRRX]; Fedex Corp., Annual Report for the Fiscal Year Ended May 31, 2018 (Form 10-K), at 13 (July 16, 2018), https://www.sec.gov/Archives/edgar/data/1048911/000156459018016877/fdx-10k_20180531.htm [https://perma.cc/98EH-TWRL]; *see also* Craig v. FedEx Ground Package Sys., Inc. (*In re* FedEx Ground Package Sys., Inc.), 792 F.3d 818 (7th Cir. 2015); Lydia DePillis, *How FedEx*

The IRS and the courts now look to a list of twenty factors to be considered in distinguishing independent contractors from employees.[93] These include whether the service provider performs according to instructions, training, and supervision of the "contractor." The more instruction, training, and supervision provided, the more likely the IRS is to treat the relationship as one of employment. On the other hand, as with other multifactor tests in the tax law, the classification of a worker as an employee or an independent contractor often rests on seemingly arbitrary distinctions. For example, whether my dog's walker is an employee or an independent contractor may depend on whether I tell her specifically what time and where to walk my dog, and on who supplies the doggie bags. An Uber driver who uses her own car, chooses her own hours, and also drives for Lyft is almost certainly an independent contractor, not an employee under the tax law. Many people who describe themselves as employees when asked by the U.S. Census are independent contractors under the tax law. The percentage of workers filing their taxes as self-employed has increased from about 13% of all workers in 2000 to more than 16% in 2012, even without the significant tax advantages to self-employed workers provided by the 2017 tax legislation.[94]

Is it sound tax policy for the tax law to provide incentives that push workers towards becoming independent contractors rather than employees? This will, for example, free businesses from complying with state laws that are designed to protect employees. It will also reduce opportunities for workers to qualify for employer-sponsored retirement and health plans. This is another legal regime that hardly seems stable.

C. Other Domestic Changes

The new law makes many other significant income tax policy changes. As discussed earlier, the $10,000 limitation on state and local tax deductions,[95] which was clearly targeted at politicians and voters in states that mostly vote for

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is Trying to Save the Business Model that Saved it Millions, WASH. POST (Oct. 23, 2014) https://www.washingtonpost.com/news/storyline/wp/2014/10/23/how-fedex-is-trying-to-save-the-business-model-that-saved-it-millions/?utm_term=.a6ea3f76f26f [https://perma.cc/Z2NZ-4H2W].

93. *See, e.g.*, *id.* at 819-20; *Employer's Supplemental Tax Guide*, INTERNAL REVENUE SERV. 7-8 (2018), https://www.irs.gov/pub/irs-pdf/p15a.pdf [https://perma.cc/3AC7-BFCU].

94. For more on the impact of this change, see Elisabeth Leamy, *Are You a Telecommuter with a Home Office? You Just Lost a Tax Break*, WASH. POST (May 29, 2018), https://www.washingtonpost.com/lifestyle/home/are-you-a-telecommuter-with-a-home-office-you-just-lost-a-tax-break/2018/05/28/7d92b1b4-5eb9-11e8-b2b8-08a538d9dbd6_story.html?noredirect=on&utm_term=.4a1b7b5844c2 [https://perma.cc/E7MJ-YTW6].

95. I.R.C. § 164(b)(6).

Democrats—may be the most controversial. For a final example, however, consider a provision that almost everyone—with the exception of certain charitable organizations—seems to like: the doubling of the standard deduction to $24,000 for married couples and to $12,000 for single people.[96] Republican leaders expressed great enthusiasm for this change, which will substantially increase the number of taxpayers who will not need to itemize deductions.

The President and the Republican leaders in Congress insisted that this change would allow the vast majority of taxpayers to file tax returns on a simple postcard—a claim they should have abandoned as unrealistic. On June 25, 2018, the IRS unveiled the postcard-sized Form 1040 that President Trump and Republicans in Congress had promised, a form the IRS said it would finalize over the summer. Treasury Secretary Steven T. Mnuchin hailed its release, saying, "The new postcard-size Form 1040 is designed to simplify and expedite filing tax returns, providing much-needed tax relief to hardworking taxpayers."[97] The new form, however, adds at least six new schedules to those that previously accompanied Form 1040,[98] bringing the total to more than thirty. A *Forbes* article remarked, "[Y]ou . . . might flashback to those college assignments where you spent hours shrinking the font, rather than editing your work, to make the text fit."[99]

The most pertinent question here is about the opportunities missed. According to the Joint Committee on Taxation, this change was estimated to cost nearly $1 trillion in foregone revenue during the 10-year budget window from 2018 to 2027.[100] Spending this money on expanding, simplifying, and reforming the Earned Income Tax Credit, for both single workers and those with children, would have been a far better policy choice. This change would have increased take-home pay for low- and moderate-income workers and could have eliminated the debilitating marriage penalties of current law. The costly increase in

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96. *Id.* § 63.

97. *Treasury, IRS Announce Development of Postcard-Size 1040 for 2019*, U.S. DEP'T TREASURY (June 29, 2018), https://home.treasury.gov/news/press-releases/sm421 [https://perma.cc/3WQQ-AY77].

98. Kelly Phillips, *Here's How the New Postcard-Sized 1040 Differs from Your Current Tax Return*, FORBES (June 30, 2018), https://www.forbes.com/sites/kellyphillipserb/2018/06/30/heres-how-the-new-postcard-sized-1040-differs-from-your-current-tax-return/#5fa0e4e246cc [https://perma.cc/6LW6-GHV2].

99. *Id.*

100. *See Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act"*, JCX-67-17, JOINT COMMITTEE ON TAX'N 1 (Dec. 18, 2017), https://www.jct.gov/publications.html?func=startdown&id=5053 [https://perma.cc/3JTB-YTWK].

the standard deduction, in contrast, simply saves a lot of middle-income taxpayers from itemizing their deductions. Here, in my view, an important opportunity was missed.[101]

CONCLUSION

Our current tax system is unstable. The sad truth is that the 2017 tax legislation moved us far away from the economically advantageous, fiscally responsible, and simplified tax reform that our nation so badly needs. In today's competitive global economy, our political leaders are hobbling our nation by relying so heavily on income taxation to finance the federal government. How have other countries managed to get their business tax rates so low? By raising their value-added taxes—taxes on consumption that are now used by more than 160 countries worldwide, including every country in the OECD except for the United States.[102]

By enacting a value-added tax of roughly 12% we could: eliminate more than 150 million people from income taxation with a $100,000 standard deduction; lower income tax rates for everyone; reduce the corporate rate to 15%; and protect low- and moderate-income families from any tax increase through payroll tax credits and expanded refundable tax credits for children administered through government-issued debit cards.[103] Senator Ben Cardin of Maryland has introduced legislation along these lines.[104] But that legislation is going nowhere now because the majority of our politicians believe they can avoid any political heat by insisting on tax cuts alone. Our political leaders simply refuse to tell the truth to the American people.

In 1990, when I was serving at the U.S. Treasury Department, President George H.W. Bush came to believe that the nation's fiscal situation required serious deficit reduction. And when George Mitchell, then the Democratic Senate

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101. *See, e.g.*, Elizabeth Kneebone, *Economic Recovery and the EITC: Expanding the Earned Income Credit to Benefit Families and Places*, BROOKINGS INST. METRO. POL'Y PROGRAM (Jan. 26, 2009), https://www.brookings.edu/wp-content/uploads/2016/06/20090126_eitc_kneebone.pdf [https://perma.cc/7L57-QFMG]; Isabel Sawhill & Quentin Karpilow, *Raising the Minimum Wage and Redesigning the EITC*, BROOKINGS INST. CTR. ON CHILDREN & FAMILIES (Jan. 20, 2014), https://www.brookings.edu/wp-content/uploads/2016/06/30-Raising-Minimum-Wage-Redesigning-EITC-sawhill.pdf [https://perma.cc/D3AT-3RCL].

102. ORGANISATION FOR ECON. CO-OPERATION AND DEV., CONSUMPTION TAX TRENDS 2016: VAT/GST AND EXCISE RATES, TRENDS AND POLICY ISSUES 19 (2016).

103. *See* MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 61-83 (2008); Michael J. Graetz, *The Tax Reform Road Not Taken—Yet*, 67 NAT'L TAX J. 419, 424-26, 430-34 (2014).

104. Progressive Consumption Tax Act, S. 3529, 114th Cong. (2016).

Majority Leader, made clear that he would not consider significant spending cuts or new tighter budget rules without tax increases, President Bush agreed to increase taxes, violating his famous "read-my-lips-no-new-taxes" pledge because he believed it was the right thing to do for the country. He knew it might cost him re-election, and it did—in no small part because of the betrayal of Newt Gingrich, who was far more interested in his own ambitions to be Speaker of the House than in what was good for the country.[105]

Five years later, Gingrich did become Speaker of the House after Bill Clinton had raised taxes in 1993—again to address the deficit—with only Democratic votes. In the 1994 election, the Republicans captured the House of Representatives for the first time since 1954. After that, political courage over the necessary level of taxes became scarce indeed. Political courage seems even more illusory in the 21st century.

But not all the news is bad. The budget legislation of the 1990s, along with the economic growth unleashed by the information technology revolution of the late 1990s, completely eliminated the projected deficits by the year 2000 and produced a federal surplus for the first time since 1969. Indeed, the budget surpluses projected by the Congressional Budget Office at the beginning of this century were so large that, in March 2001, Chairman of the Federal Reserve Alan Greenspan told Congress that the federal government would soon pay off all of the national debt and would have to begin investing its surplus revenues in corporate stocks, a prospect he abhorred. The good news is that this problem has been solved.

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105. The story of Gingrich's betrayal is told in RICHARD DARMAN, WHO'S IN CONTROL? POLAR POLITICS AND THE SENSIBLE CENTER (1996).