The Games They Will Play:

Tax Games, Roadblocks, and Glitches Under the New Legislation

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This joint report reflects insights from many tax scholars, practitioners and analysts. The primary drafters are Ari Glogower, David Kamin, Rebecca Kysar, and Darien Shanske. All errors are our own.

Executive Summary

This report describes various tax games, roadblocks and glitches in the tax legislation currently before Congress.

The complex rules proposed in the House and Senate bills will allow new tax games and planning opportunities for well-advised taxpayers, which will result in unanticipated consequences and costs. These costs may not currently be fully reflected in official estimates already showing the bills adding over $1 trillion to the deficit in the coming decade. Other proposed changes will encounter legal roadblocks, that will jeopardize critical elements of the legislation. Finally, in other cases, technical glitches in the legislation may improperly and haphazardly penalize or benefit individual and corporate taxpayers.

This report is not intended as a comprehensive list of all possible problems with the drafting and design of the House and Senate bills. Rather, this report highlights particular areas of concern that have been identified by a number of leading tax academics, practitioners, and analysts.

In particular, the report highlights problems with the bill in the following areas:

- **Using Corporations as Tax Shelters**

  If the corporate tax rate is reduced in the absence of effective anti-abuse measures, taxpayers may be able to transform corporations into tax-sheltered savings vehicles through a variety of strategies. For instance, at the most extreme, it may be possible to shield labor income in a C-corporation so that it faces a final tax rate of only 20%.

- **Pass-Through Eligibility Games**

  Taxpayers may be able to circumvent the limitations on eligibility for the special tax treatment of pass-through businesses. For instance, under the Senate bill, many employees—such as law firm associates—could become partners in new pass-throughs and potentially take full advantage of the special tax treatment.

- **Restructuring State and Local Taxes to Maintain Deductibility**

  The denial of the deduction for state and local taxes will incentivize these jurisdictions to restructure their forms of revenue collection to avoid this change. This could undercut one of the largest revenue raisers in the entire bill.

- **International Games, Roadblocks, and Glitches**

  The complex rules intended to exempt foreign income of domestic corporations from U.S. taxation present a variety of tax planning and avoidance opportunities. For instance, one provision would encourage sales of products abroad, only for those products to be sold right back into the United States. Furthermore, several of these rules are likely to be non-compliant with both World Trade Organization rules for international trade and our network of bilateral tax treaties. Some of these rules also create perverse economic incentives, like advantaging foreign over domestic manufacturers.

- **Arbitrage Money Machines**

  The variety of tax rates imposed on different forms of business income in different years invite arbitrage strategies, whereby taxpayers can achieve an economic benefit solely based on the timing and assignment of their income and deductions.

- **Other Glitches**

  Other glitches in the proposed bills would haphazardly penalize taxpayers. For example, the reintroduction of the corporate AMT at the 20% rate in the Senate bill would vitiate key tax incentives and the basic structure of the international reforms. The proposal in the House bill to tax capital contributions to entities could penalize taxpayers for no justifiable reason.

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I. Introduction

The tax legislation now before Congress was written quickly, leaving legislators and the public little time to analyze its provisions—many of which are highly complex. Tax lawyers and accountants are already preparing to exploit ambiguous and poorly drafted provisions in the bill. Because of these tax-planning opportunities, it is likely that the actual cost of this legislation will exceed the current projections of over $1 trillion.

In a handful of cases (such as the last minute addition of the corporate AMT), some of the unintended or opaque consequences of the bill might cut the other direction—and raise taxes on businesses and individuals in unexpected ways. But we suspect that in the end, the wealthy and well-advised will benefit disproportionately from these errors of oversight and haste. The corporate AMT mistake will almost certainly be corrected according to reports, while many of the largest loopholes may remain in the final bill. Thus, unless Congress makes a number of substantial changes, the final legislation could deliver much larger benefits to some of the best off (and their advisors) than even current estimates might suggest.

The bills from the two houses are now headed to conference committee. As Congress tries to negotiate final legislation, we offer a list covering three categories: (1) Tax games. These describe some of the key areas where we believe tax planning is likely to occur. (2) Roadblocks. These include areas in which the legislation may interfere with important non-tax policies and encounter legal roadblocks as a result (e.g., by causing the United States to violate international trade law). (3) Glitches. These are mistakes or ambiguity in the drafting that could lead to uncertainty and haphazard increases or decreases in taxes.

Congress should immediately reconsider its approach. Put simply, these bills are right now riddled with problems and, especially in light of likely future gridlock in Washington, it is very important to get this right the first time.

This document reflects the collective work of a number of tax scholars, practitioners and analysts, and represents our different areas of expertise and viewpoints. There are places where some of us might even disagree with others on the proper interpretation of a provision and the wisdom of a policy, but we all agree that the areas described below urgently need more attention.

This is also not a comprehensive analysis. That would take much more time and space than we now have, and, on a number of these topics, we are confident that more time and more writing will only lead to identification of more such problems.

Many of us also object to the basic structure and motives of the legislation: a revenue-losing bill that directs disproportionate benefits to businesses and wealthy investors, and is expected to leave low and middle income Americans worse off in the end. But our present concern is more specific. This report focuses on areas where complexity, variations in tax rates, poor drafting,

and a failure to consider our international obligations could lead to uncertainty, additional windfalls for sophisticated taxpayers, and significant costs to everyone else. We also highlight areas where these factors—and others—are likely to dramatically drive up the true revenue costs of these provisions.

We begin with a description of some of the relevant tax games, roadblocks, and glitches that would arise from the Senate and House bills, and then describe a number of the more complex areas further in the Appendix.

II. Tax Games, Roadblocks, and Glitches

A. Using Corporations as Tax Shelters

Both the House and Senate bills would tax corporate income at a flat rate of 20%. Without effective anti-abuse provisions, this change would encourage taxpayers to use the corporate form as a tax-sheltered savings vehicle.

The basic advantage to investing through a corporation is that income is not currently taxed to the investor. The cost of investing through a corporation, however, is the "double tax" on income, both to the corporation (when income is earned) and to the investors (upon a distribution or sale of their corporate interest). If, however, the corporate tax is reduced, taxpayers can use the corporate form to shelter their income from tax.

In combination, the 20% corporate rate and the later second layer of capital gains or dividend tax can produce a rate roughly equivalent to the top ordinary rate. But, deferring or potentially even eliminating the second layer of tax then makes the C-corporation preferable to simply earning the income as an individual subject to the top rate. Corporations can also deduct the state and local income taxes that individuals cannot, which will provide another incentive for individuals to form corporations.

The benefit of a low corporate tax rate is compounded by other structural features of the income tax. Both the House and Senate bills would preserve the "basis step-up" upon a taxpayer's death. As a result, investment income held through a corporation can first accrue at a low rate during the investor's life. The investor's heirs can then inherit the corporate interest with a basis equal to its fair market value, and thereby eliminate the second individual layer of tax. There are also other methods described below for avoiding the second layer of tax.

As analysts including Mike Schler, Adam Looney, and Ed Kleinbard have described,[1] a low corporate tax rate invites myriad planning opportunities.[2] Here are a few (with much of this analysis a credit to their work). These examples are described in greater detail in the appendix.

- **Stuffing the C-corp.** The simplest strategy is for a taxpayer to invest through a corporation so her investment income accrues at the lower corporate rate. This strategy will be particularly advantageous in the case of fixed income investments (like interest on bonds), which would be taxed at rates of up to 43.4%, more than twice the rate of tax on that same income when held through a corporation.[3] However, taxpayers can achieve a significant benefit in the case of domestic equity investments as well, because dividends received at the corporate level will now be taxed at a reduced 10% rate as compared with a 23.8% rate for dividends received outside the corporation.[4] These benefit will be compounded if the taxpayer passes on the interest to her heirs or uses other methods described below for avoiding the second layer of tax.

- **Transforming labor income into corporate profits.** Taxpayers will relatively easily be able to shield their labor income from the high ordinary tax rate by simply setting up a corporation (or checking the box so that a partnership or other entity is treated as a corporation for tax purposes), and having their income accrue in the form of corporate profits. This has the potential to permanently shield labor income from a higher rate if combined with step up in basis or other methods for avoiding the second layer of tax.

- **Salaries in closely held corporations.** Relatedly, shareholder-employees in a closely held corporation can achieve the same effect by reducing their wages paid out by the corporation, thereby increasing the corporation's retained profits. In effect the shareholder-employees derive the benefit of immediately reinvesting their pre-individual-

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[1] See Michael L. Schler, Reflecting on the Pending Tax Cut and Jobs Act, *Tax Notes* (forthcoming, manuscript on file); Adam Looney, Brookings Institution, The Next Tax Shelter for Wealthy Americans: C-Corporations, Up Front Blog, (Nov. 30, 2017), https://www.brookings.edu/blog/up-front/2017/11/30/the-next-tax-shelter-for-wealthy-americans-c-corporations/. In a prescient article, Ed Kleinbard several years ago also addressed the problems of stuffing into C-corporations once their rate falls below the top individual rate. See Edward Kleinbard, "Corporate Capital and Labor Stuffing in the New Tax Rate Environment" (March 21, 2013), https://ssrn.com/abstract=2239360.

[2] As Mike Schler notes, general anti-abuse rules, such as assignment of income principles and the economic substance doctrine, may discourage the most severe abuses. There are other anti-abuse rules that would govern as well, such as those governing retained earnings and personal holding companies. However, the existing rules are notoriously porous and easy to evade. Further, even better anti-abuse rules cannot effectively police all tax planning behavior and would be costly for the IRS to enforce. For further discussion, see the Appendix. *See also* Kleinbard, *supra* note 1.

[3] The 39.6% top marginal rate plus the 3.8% NIT.

[4] The 10% rate results because the House and Senate bills both allow corporations a 50% deduction for dividends received from other domestic corporations. The resulting rate is 20% × 50% = 10%, which is less than half the top rate on qualified dividends paid to individuals (20% plus the 3.8% NIT).

tax labor income within the corporation, where it can accrue returns at the lower corporate rate.

- **Avoiding the second layer of tax.** The tax savings from using the C-corporation become super-charged if the second layer of tax is avoided. This can be done a number of ways:

  - **Step up in basis.** As already noted, the C-corporation stock can be held until death at which point the second level of tax is entirely wiped out due to "step up" in basis.

  - **Roth retirement accounts.** In effect, a corporation taxed at a low rate operates as a "quasi-Roth" account. If the taxpayer is in fact saving for retirement, however, even greater planning opportunities arise. A taxpayer is allowed to hold shares in a closely held corporation in her Roth account, which exempts future investment returns from tax. If the taxpayer is also an employee of the corporation, she may forego a portion of her salary in exchange for higher corporate profits that will be completely exempt from individual tax. In a Roth account (and assuming distributions occur in retirement) the second level of tax would never be imposed.

  - **Lower tax rates in retirement.** Even if the corporate interest is not held in a Roth account, the taxpayer may similarly reduce the individual level tax by waiting until retirement to receive distributions, when the taxpayer may be taxed at lower marginal rates.

  - **Other strategies.** There are also other strategies for avoiding the second layer of tax—such as the partial exclusion for gains on investment in certain "small business" stock.

Of course, a taxpayer could engage in any of these activities now under current law. The key difference is that the current cost of the relatively high corporate tax limits the benefit from these strategies. The current structure of the income tax is poorly equipped to address a scenario in which corporations are taxed at a much lower rate than individuals. If Congress intends to transform the corporate form into a tax-preferred savings vehicle, new rules are required to prevent abuse. Unfortunately, such rules are sorely missing from the proposed House and Senate bills.

Solutions: Planning opportunities will arise whenever the corporate tax rate is significantly less than the individual rate. Smaller fixes could scale back the most egregious opportunities for abuse, but more aggressive measures could create other inefficiencies.

- **Eliminate the basis step-up.** Eliminating the step-up in basis at death would prevent taxpayers from completely avoiding the individual-level tax on corporate investments

held for their entire lifetime. This partial solution, while an important step, would preserve significant tax planning opportunities.

- **Further reduce the dividends received deduction for non-affiliates.** While the House and Senate bills both reduce the deduction for dividends received from an unaffiliated domestic corporation (from 70% to 50%), this still results in a very low 10% corporate tax rate on dividends received. Further reducing or eliminating the deduction for dividends received from unaffiliated domestic corporations would make it less attractive for taxpayers to stuff C-corps with equities, while not interfering with the planning decisions of C-corporations that use affiliated subsidiaries for business purposes.

- **Anti-abuse rules.** Congress and Treasury could tighten general anti-abuse rules in the tax law, such as the personal holding company and accumulated earnings tax provisions, but overly restrictive limitations would interfere with a corporation's legitimate business decisions as to when and how to deploy capital. Limitations on the ability to incorporate for tax purposes would require complex rulemaking and line-drawing.

- **A comprehensive solution.** If Congress is committed to reducing the corporate tax rate well below the top individual rate, more fundamental structural changes to the income tax are necessary to avoid the gaming opportunities described above. Corporate earnings could be taxed currently at the individual level through either pass-through treatment (for small closely held corporations) or mark-to-market taxation (for large publicly traded corporations). This change would in turn allow for closing the rate gap between capital and labor income. This package of reforms would neutralize the benefits of investing through corporations, and allow for the reduction or even the elimination of the corporate tax.

B. Pass-Through Eligibility Games

The lower tax rate on pass-through income provides special tax relief to a swath of business owners, with most of the benefit concentrated among those with the highest incomes. The provisions in the bills from both houses are complicated, and seem to intentionally benefit an array of special interests and particular types of capital owners. The various lines drawn by the provisions will result in substantial tax planning and lower taxes for anyone able to characterize their livelihood as an eligible business rather than as a job.

These games are separate from those that can be played with C-corporations. In some cases, it will be more advantageous to take advantage of pass-through rates; in other cases, a C-corporation shelter would be preferable. Importantly, it will be the taxpayer's choice, and, either

way, the result is that the taxpayer will avoid tax at the top individual rate—and will instead enjoy a lower, preferential rate, whether via a C-corporation or pass-through.

In particular, taxpayers may be able to game the pass-through provisions through the following strategies, each of which is described in greater detail in the Appendix:[5]

- **Law firm associates, LLC.** Under the Senate bill, there is potentially a major problem as drafted: Employees may be able to benefit from the pass-through provision by forming a pass-through of which they are an owner. To achieve the tax savings, no longer be an employee (who cannot benefit from the provision); instead be an owner (who can benefit from the provision). For example, law firm associates (and other employees of the firm) should no longer be mere associates. They should instead be partners in Associates, LLC—a separate partnership paid to provide services to the original firm.[6] Their "profit share"—in lieu of salary—from Associates, LLC would then be given the special low pass-through rate. There are restrictions on lawyers—since they provide a personal service, which is disfavored in the bill—from benefiting from the special pass-through rate, but those restrictions would not apply to these associates. So long as the associate (or really partner in Associates, LLC) makes less than $500,000 in taxable income (for a married couple) or $250,000 (for a single individual), they would be fully eligible. And that covers a lot of law firm associates, not to mention many other people who are now employees—but who may not be for long.

  The same loophole might even apply to the "self-employed." This could further expand revenue loss and encourage people, when able, to either mischaracterize or rearrange relationships to be independent contractors rather than employees.

  It is possible that the Senate does not intend the provision to benefit service providers like this. An alternative interpretation—and a possible one based on existing doctrine and the legislative language—is that these service providers won't benefit to the extent the profits allocated to them represent "reasonable compensation" for their services. At present, though, this limitation is inconsistent with parts of the legislative history, and the text can be reasonably read to provide otherwise. The legal details are described in the Appendix. If Congress does not intend to write in such a massive loophole into the bill, it should act now to clarify—and not hope the IRS will staunch what could be a major bleed in revenue and a giveaway disproportionately benefiting those with high incomes.

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[5] These examples all come from analysis by Dan Shaviro, Mike Schler, and Victor Fleischer, and, in some cases, all of them. For Dan Shaviro's analysis of the pass-through loophole, see here. See also Schler, *supra* note 1, and Victor Fleischer here.

[6] The associates could also be made non-voting partners in the original partnership itself, but, as David Miller points out, firms are sensitive to issues like "profits per partner" and so would probably prefer the associates be separated. This strategy might also reduce the risk of the profit shares for the associates being deemed "guaranteed payments," which would not benefit from the lower pass-through rate.

- **Go passive or get some capital.** Under the House bill, the key to the preference is not just to be an owner but, in addition, to be a passive owner rather than an active worker at the firm—effectively granting a subsidy to those who work less. Taxpayers would respond accordingly, by appearing to reduce their active involvement in the business. If it's a family owned business, owners could make sure no one family member spends too much time running the firm. Or an owner could swap ownership interests with someone else running another firm—and be passive investors in each other's firms. Or owners could split apart lines of business—and the time the owner spends in each—so that the owner does not "materially participate" in in a single business. Another option is to get capital in the firm, which can allow owners to apply the lower pass-through rate to other income—since the legislation assumes a very high rate of return to such investments. Lawyers and doctors should buy their own buildings as a result (unless they're a large firm, in which case there may be an even more tax favored way to hold the building).

- **Split apart—or the famous athlete's brand company.** As the *Washington Post* points out, some people who are subject to the line of business restrictions—which denies the special pass-through rate to lawyers, doctors, athletes, and others (to all in the House bill and above certain income thresholds in the Senate bill)—might still be able to benefit. One strategy is to split off the brand name (such as the brand of a famous athlete or a major law firm). Put the brand in a separate pass-through which manages the brand but does not engage in the restricted business. The result is that a nice swath of income—the income attributable to the "brand" rather than the restricted services—gets the lower pass-through rate.

  Under the Senate bill, there still might be a problem in taking the pass-through deduction—the firm would need enough employee wages. Firms that don't pay wages can't take the deduction. One workaround would be to hire some employees, and perhaps even only one, such as the athlete. The athlete could collect just enough wages through this company to take the pass-through deduction on the rest of the income.

Solution: The best answer would be to eliminate the pass-through provisions entirely. As many have described, the favorable pass-through provisions in the House and Senate bills are unjustified and inherently subject to such gaming and planning. At best, the provisions disproportionately and peversely benefit passive investors. If Congress wants to keep a preferential rate using the basic structures now on the table, it should strengthen the guardrails to avoid a much larger giveaway than lawmakers may intend to offer:

- Under the Senate bill, lawmakers should clarify that people providing labor services cannot fully take advantage of the pass-through deduction by simply forming as a partnership or being independent contractors (taking some of the juice out of the Law Firm Associate LLC game). They should at the least be required to exclude any

partnership profits or self-employed business earnings that represent "reasonable compensation" for services from the benefit.

- Under the Senate bill, lawmakers should strengthen the Senate's requirement that a pass-through must pay wages to get the deduction (making the Famous Athlete's Brand Company game harder). Someone shouldn't be able to pay salary to themselves for instance to generate eligibility. The requirement of paying salary should also be adopted as a guardrail in House version of the legislation.

- Under the House bill, the assumed return of capital should be lowered so that capital investments (like a building) can't be used to give other income (like from lawyering) the lower, pass-through rate.

C. Restructuring State and Local Taxes (SALT) to Maintain Deductibility

Under both the House and Senate bills, the itemized deduction for state and local taxes for individuals is limited to $10,000 and is only available for property taxes. This change is among the largest revenue raisers in the entire legislation, though we believe estimates do not currently take into account the likely state response. There are numerous ways for states and localities to reshape their tax systems so as to respond to this change and retain the benefit of the deduction for their taxpayers. The key is to shift toward deductible taxes without changing significantly who pays the taxes as an economic matter. SALT is being scored a big revenue raiser, but administrative adjustments—some relatively small—that allow state taxpayers to retain the SALT benefit must be anticipated.

As described further below, many of us belive Congress should retain much, if not all, of the SALT deduction; however, if Congress plans to limits the deduction—and if this change is expected pay for a large portion of the bill—the response of state and local governments should be taken into account.

In particular, states and localities could use the following deductible taxes in place of non-deductible individual income taxes:[7]

- **Property taxes.** One way for states to achieve this is by shifting to use of the property tax. The liquidity impact on taxpayers of a shift to property taxes can be mitigated by circuit breakers administered through a state's income tax—essentially, reducing income tax liability in exchange for higher property taxes. Such responses would effectively

[7] The analysis of SALT tax planning arising from the tax bill represents a summary/expansion of previous analysis done by Darien Shanske, Daniel Hemel, David Kamin, Manoj Viswanathan, Kirk Stark, and Phillip Blackman.

allow taxpayers to deduct the full amount of state and local property *and* income taxes, up to the $10,000 cap.

- **Employee payroll taxes.** Another tax which could be used in place of a state income tax is a state payroll tax with legal incidence on the employer. Since the tax is levied on the employer, the employer would still be able to deduct the taxes—even as it would function, in economic terms, very similarly to an income tax imposed directly on the employee.

- **Charitable gifts.** State and local governments can make it easier for taxpayers to make charitable donations to the jursidictions, which would then be credited against state income taxes.

- **Business "franchise" taxes on pass-throughs.** Business "franchise" taxes—taxes imposed on the business entity—appear to remain deductible even if imposed on pass-throughs (and so deducted by the individual). These are sometimes based on the capital or net worth of the firm, or, in the case of New York City, even on the income of the firm (though, unlike with other franchise taxes, it is not clear if one imposed explicitly on business income would remain deductible to individuals). States could shift to such franchise taxes and then link them up to their individual income tax systems—for instance, reducing individual income tax liability based on franchise tax payments.

Solutions: There are no easy solutions to prevent restructuring to maintain SALT deductibility. Three general directions are possible:

- **Reduce or eliminate the cutback.** A number of us believe that at least a partial deduction for state and local taxes is justified. Simply reducing or eliminating the cutback would lessen the incentive for states to restructure their revenue collection mechanisms.

- **Use a realistic revenue estimate and offset the additional cost.** If a cap at the level in the current proposals is preserved, revenue estimates should be adjusted to reflect states and localities responding to maintain deductibility—and Congress should be forced to come up with other revenue raisers to make its budget math work.

- **Broaden the scope and phase in the cap.** To reduce the states' incentive to game the cutback, Congress could set a single cap on *all* possible state and local taxes rather than permit just one kind of tax to be deducted. The cap should also be set higher than the proposed $10,000 limit and phased in at higher income levels to reduce the gaming incentive. Implementing a single integrated cap and a phase-in schedule, however, could require additional complexity, particularly in light of different revenue-raising instruments used in different jurisdictions.

D. International Games, Roadblocks, and Glitches

The international provisions are among the most complex in the legislation. They deserve serious attention and, as illustrated below, present numerous gaming opportunities, adverse consequences under international law, and undesirable incentives to locate investment and assets abroad. To be sure, the current system also is the subject of considerable tax planning, avoidance, and inefficiency. But, the proposed system will introduce significant new problems.[8]

The basic structure of the international reform is to (1) exempt foreign income of U.S. corporations from taxation in the United States (a territorial system); (2) backstop the territorial system with a 10% "minimum tax" on foreign-source intangible income (the GILTI regime in the Senate and the high profit foreign-subsidiary regime in the House); (3) provide a special low rate on export income in the United States (the FDII regime, in the Senate bill only); and (4) target profit-stripping by foreign firms operating in the United States (the excise tax in the House and the BEAT in the Senate).[9]

Here are a few examples of the problems with these reforms, with supplemental analysis in the Appendix:

- **The minimum tax formula induces companies to locate real assets and investment offshore.** Congress is right to be worried that U.S. corporations are incentivized to shift profits out of the United States, and especially through intangibles. This dynamic is potentially aggravated by the exemption of foreign source profits from taxation under the new system. However, the minimum tax, as structured, is highly problematic. It exempts a deemed 10% return on tangible assets, measured by tax basis. This pushes U.S. firms in the direction of locating real assets (and accompanying jobs) overseas rather than domestically. Furthermore, because the minimum tax is applied on a global basis (rather than country-by-country), firms are also incentivized to locate investment in low tax countries and blend that income with income from high tax countries.

- **The minimum tax on intangible income can be avoided through leveraging.** A firm can load up on tangible property abroad—potentially just borrowing to buy assets—and thereby shield "intangible" income (potentially stripped out of the United States) from taxation.[10]

[8] This section on international taxation reflects the work and insights of Rebecca Kysar.
[9] This discussion ignores the unintended effects on the international provisions from the reinstatement of the corporate AMT in the Senate bill, an issue that is flagged below and likely to be resolved in conference.
[10] Thanks to Mitchell Kane for this insight on using investment in tangible assets to shield intangible income. Mike Schler also discussed the leveraging point in his article. Schler, *supra* note 1, at 44.

- **<u>Solutions</u>:** The problem with loading up on tangible assets could be addressed by, among other solutions, applying the minimum tax to all foreign source (non-subpart F) income, without any exemption for a return to tangible assets. The problem of blending could be addressed by moving to a country-by-country minimum tax rather than one done on a global basis. Both of these options, however, could be critiqued as moving too far in the direction of worldwide taxation. If this is a concern, the minimum tax could be imposed at a lower rate. Caution should be taken in lowering the rate, however, since this would impact revenues and would also lead to increased profit shifting and base erosion by widening the disparity between the domestic rate and the foreign minimum rate.

  A less drastic option would be for debt to reduce tangible asset basis to some degree for purposes of the minimum tax. Alternatively, one could ignore debt and instead exempt an amount equal to a risk-free rate of return to the equity in each CFC. If one does not limit the ability to use leverage, then at the very least the 10% deemed return on tangible asset basis could be set at a lower percentage rate.

- **Problems with the special low rate on export income associated with intangibles: roundtripping products, advantaging foreign over domestic manufacturers, and WTO non-compliance.** The special low rate of 12.5% in the Senate bill for export income is intended to encourage firms to keep and develop intangible property in the United States. But, it could easily undermine the U.S. tax base while also being an unstable solution due to possible WTO non-compliance. First, corporations can play a seemingly easy game to get the special low rate on exports, even for sales actually occurring in the United States. They can roundtrip products. A corporation is encouraged to sell abroad, only to have those products then sold right back home; the result is an apparently low special rate.

  The low rate also encourages firms to sell unfinished products to foreign manufacturers rather than domestic manufacturers, since the former transaction would get the low rate and the latter would not. This is a perverse economic incentive in a bill purportedly dedicated to increasing investment and jobs in the United States.

  Further, although the export subsidy regime was touted as promoting neutrality in the decision of where to locate IP, foreign intangible income faces a lower 10% rate in the Senate bill, which means that firms may still choose to locate IP abroad. This disparity in rates leads to an unstable and peculiar result: We tax the item we want to favor (exports) more onerously than the item we want to disfavor (foreign intangible income).[11]

[11] Thanks to Mitchell Kane for this point.

Finally, this low rate on export income likely runs afoul of WTO rules, and so is not a stable reform. The way that the rate is calculated means that the greater the U.S. taxpayer's income from exports, the more of its income gets taxed at the special low rate. As such, it is likely an illegal export subsidy in violation of the United States' WTO obligations.

- **Solutions:** Especially in light of these incentives, the likely incompatibility with WTO rules, and the lack of evidence as to whether patent boxes increase R&D and employment,[12] the better course of action is to drop this export incentive entirely. If the committee wishes to retain the special rate, to effectuate the purported goal of neutralizing investment decisions, the minimum tax rate should be raised to at least 12.5%. At minimum, the law should establish roundtripping rules that prevent easy gaming of the export subsidy (though perverse economic incentives would remain).

- **Problems with inbound provisions meant to prevent earnings stripping using foreign affiliates, especially by non-U.S. corporations: WTO and tax treaty non-compliance.** The problem of earnings stripping using deductible payments between a U.S. subsidiary and a related foreign entity is a serious one, especially among non-U.S. corporations which aren't currently subject to rules restricting this strategy. Both the House and Senate bills try to address this problem by imposing a tax liability on such deductible payments to a related foreign entity. However, both provisions could be characterized as a forbidden charge on importation or a discriminatory internal tax—in violation of the WTO rules. Additionally, they both pose problems for our network of bilateral tax treaties, especially the House version for reasons discussed further in the Appendix.

  - **Challenges:** Solving the myriad problems under international law is not easy. The United States should anticipate immediate WTO challenges to the inbound regimes. The United States should also anticipate pressure from our treaty partners to scale back the inbound regime via treaty, and the revenue estimators should anticipate this reaction. When it comes to tax treaty obligations, the Senate provision is superior to the House one, but, in either case, the United States should be prepared to devote significant resources to litigating and renegotiating our international agreements.

[12] Michael J. Graetz, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 Columbia Law Review 347, 375 (2013).

E. Arbitrage Money Machines: Gaming the Rates Differentials on Business Income

The variety of tax rates imposed on business income do not just generate incentive to try to get income taxed at the lowest rate possible (though it does that); it also incentivizes "arbitraging" to generate income taxed at low rates and related deductions taken against high rate income. The result is a money-machine, with the government essentially paying taxpayers who successfully pull off such transactions. This can be done in a variety of ways under the legislation. For instance:[13]

- **High rate in 2018, low rate in 2019 (or who wants to have fun with equipment!).** In the Senate legislation, the corporate rate reduction from 35% to 20% is delayed for a year, from 2018 to 2019. As Dan Shaviro describes, this means that corporations predictably know that costs will be written off against a high rate in 2018 (35%), and income will be included at a low rate (20%) in 2019 and thereafter. It's an easy arbitrage opportunity, especially in combination with expensing in 2018. With appropriate counterparties, firms can buy equipment in 2018, place that equipment in service, and even then just sell it in 2019 at a gain. In doing so, they'd take advantage of a 15 percentage point rate differential, writing off against a higher rate and including the income at a lower rate.

- **Profits before losses in pass-throughs.** In the pass-through context, Congress recognized there was a potential arbitrage opportunity, but only came up with a partial solution. In particular, tax writers understood that it would be a problem if pass-through losses were written off against ordinary income at a high rate, while pass-through income was then taxed at a low rate under the new rules. However, Congress's solution was not to prevent pass-through losses from being deducted against ordinary rate income. Rather, if the losses come first, there is then a later restriction on how much pass-through income is subject to the preferential rate to the extent of those losses. This then permits a one-time way around the rule: time the income to come first and losses second. The result: the tax arbitrage works as income is included at a low rate and the eventual losses are deductible against a high rate and without a later detriment. In the Senate bill, this game would be limited to some degree by the cap on pass-through losses (limit of $500,000 for a married couple/$250,000 for a single individual of such losses applied against other income), and the IRS could try to move to recapture some of the benefit—but it is certainly subject to more mischief than immediately limiting the rate at which the losses are deductible.

- **Deals among firms.** There will often be a variety of firms in business with one another, whether through partnerships or otherwise. To the degree that there are simply more

[13] This discussion represents a summary of analysis done by Daniel Shaviro, Mike Schler, and David Kamin, among others.

entities with more variance in tax rates, there is greater opportunity to try to assign losses/deductions (for tax purposes) to the one taking those deductions against higher rate income while assigning income to the opposite. There are rules meant to restrict such maneuvers, but they already occur nonetheless, especially in the partnership context but in others too.

- **Solution:** The solution is fewer of the rate differentials that generate these kinds of arbitrage opportunities. Do not have the predictable rate cliff in 2019 that will generate so many games beforehand; do not apply special tax rates to pass-through income but to the extent that you do, make sure related losses must be taken against that rate.

F. Other Glitches Which Could Haphazardly Penalize Taxpayers

The haste with which these bills were written have left in a variety of other glitches and problems, some of which may haphazardly penalize taxpayers. For instance:

- **Accidental corporate AMT in the Senate bill.** In the Senate bill, the corporate AMT was (now infamously) retained at the last minute before passage. The problem is that the corporate AMT's tax rate—of 20%—is the same as the new regular corporate income tax rate. Since certain preferences are not allowed in calculating the corporate AMT, those preferences were essentially eliminated in the move (since the statutory rates are otherwise the same). That includes the effective elimination of the Research and Experimentation Tax Credit for large corporations, as well as the full or partial reversal of a number of the structural reforms to the international tax system—with the AMT apparently creating something close to a worldwide rather than a territorial tax regime.[14] Some of these moves we might consider better than the alternative in the bills, but they were surely unintended—and seem likely to be reversed in conference. Nonetheless, they illustrate the significant pitfalls in trying to legislate so quickly. In this case, the basic structure of the corporate tax system turned out to be something fundamentally different than intended.

- **Taxable contributions to capital.** As Mike Schler has pointed out, the House bill provides that capital contributions to any entity are taxable to the entity, unless the contributor receives stock or other equity in the transaction. This rule overturns longstanding rules that capital contributions are generally not taxable to the receiving

[14] *See* Neil Barr et al., "Last Minute Retention of Corporate AMT in Senate Tax Bill has Unintended Consequences," Tax Reform and Transition, Davis Polk (2017), https://www.taxreformandtransition.com/2017/12/last-minute-retention-of-corporate-amt-in-senate-tax-bill-has-unintended-consequences/ (last visited Dec 7, 2017).

entity. The rule is broadly written, and could lead to a variety of unintended consequences with adverse effects on taxpayers and businesses.[15] For example, this rule could result in taxable income whenever a non-pro rata contribution is made to an entity and equity is not issued in the exchange. This could easily arise in the case of contribution to a corporation by a large shareholder without a proportionate contribution by a minority shareholder, or a contribution by limited partners to a hedge fund or to a private equity fund, without a proportionate contribution by the general partner with respect to its profits interest. This rule could also create unintended taxable events when capitalizing different entities within a corporate structure. Finally, the rule could lead to uncertain application of the tax law when properties with built-in gains and losses are contributed to an entity in exchange for a partial or misvalued equity interest.

III. Conclusion

The analysis in the report reflects the collective efforts of members of the tax community over the preceding weeks to scrutinize the proposed changes, and to identify the areas that could create adverse and unintended consequences. Further problems with the bills are likely to emerge. These tax games will reduce tax revenues and thereby increase the true cost of the legislation and make the legislation more regressive than it now appears. Furthermore, additional tax complexity will be necessary in order to police the new rules and to prevent these abuses, ensuring that this legislation will move us further away from the goals a simpler, more equitable, and more efficient tax system. Finally, the IRS and Treasury may be overwhelmed in their efforts to police the new and manipulable rules during a period of reduced funding and budgetary constraints.

As described in the introduction, our immediate concern in this report is not the underlying policy motivations of the tax reform (though a number of us have separately expressed objections to these motives), but rather with the way that these goals are effectuated through the proposed statutory changes. The House and Senate versions of the bill were drafted through a rushed and closed process, without adequate regard for the intricacies of the tax law and the risk of unintended consequences. This report illustrates exactly why a transparent and deliberative process is crucial when introducing dramatic changes to the tax law.

Many of the problems that we identify do not have easy solutions. Tax planning is likely to arise whenever certain activities or taxpayers are granted favorable treatment, as taxpayers and their advisors restructure transactions to qualify for the favorable treatment. Effective rules are needed to prevent these abuses, but are in many cases inadequate under the proposed legislation.

[15] These unintended results, and others, are described in Schler, note 1, at 22-26.

We urge the members of the Senate and House to reassess the tax reform process and the resulting legislative proposals, and to undertake a more deliberative approach to far-reaching legislation that will significantly effect our economy and taxpayer behavior.

IV. Appendix

This Appendix provides greater detail on the tax games, roadblocks and glitches described above.

A. Using Corporations as Tax Shelters

Under current law, the top statutory tax rate is 39.6% for ordinary income and 20% for qualified dividends and long-term capital gains, before accounting for the Pease provision, employment and self-employment taxes, the additional Medicare tax on high earners, and the net investment income tax. The Pease provision potentially adds approximately 1.2 percentage points to a taxpayer's marginal rate, while taxes on employment, self-employment, and net investment income add up to 3.8 percentage points. Thus, the top marginal rate is 44.6% for ordinary income and 25% for qualified dividends and capital gains.

The House and Senate bills both eliminate the Pease provision, and the Senate bill reduces the top statutory rate on ordinary income from 39.6% to 38.5%. Neither bill affects the statutory tax rate on qualified dividends and long-term capital gains or alters employment and self-employment taxes or the net investment income tax. Thus, the top marginal tax rate on ordinary income will be 43.4% under the House bill (39.6% + 3.8%) and 42.3% under the Senate bill (38.5% + 3.8%), while the top marginal rate on qualified dividends and long-term capital gains will be 23.8% under both bills. The corporate tax rate will be reduced from a top rate of 35% under current law to a flat 20% rate under the House and Senate legislation.

In the examples that follow, assume that a taxpayer in the highest bracket has $1,000 available for investment, and can earn an annual pretax return of 4% on this amount through a fixed-income investment for a ten-year period. Under a baseline case, if the taxpayer invested the money directly, the return would be taxed at the 43.4% rate, for an annual after-tax return of 2.26%. After ten years, the investment would grow to approximately $1,250.

- **Stuffing the C-corp.** In the simplest example,[16] the taxpayer contributes the $1,000 to a corporation, and the investments returns accrue within the corporate solution. If the 4% annual return is taxed at the 20% corporate tax rate, the investment earns an after-tax rate of return of 3.2%. After ten years, the investment would grow to approximately $1,370. If this amount is distributed and the $370 of earnings are taxed at the 23.8% rate, the investor will be left with a total after-tax return of $1,282. Even with the double tax, the investor has earned a somewhat higher after-tax return by investing through a corporation.

[16] This example is similar to the one presented by Schler, Schler, *supra* note 1, at 1-2.

Now consider the result if the taxpayer dies at the end of Year Ten, while the investment is still held by the corporation, and her heirs receive a stepped-up basis in the corporate shares. The heirs will take a basis in their shares equal to the fair market value of $1,370, and the entire $370 of income entirely escapes the individual level tax. The taxpayer earned almost a 10% premium by investing through the corporation.[17]

Of course, a similar result is achieved under current law when a taxpayer holds any asset until death. The House and Senate versions of the tax bill, however, would dramatically expand the availability of this strategy. As illustrated above, a low corporate tax rate allows this strategy to be used to defer income from fixed-income investments, which would otherwise generate current income to the taxpayer and would not present any opportunities for deferral.

The same strategy may also be used to reduce the effective tax rate on investments in dividend-paying stocks, even though the dividends would otherwise be taxed at a preferential rate to the individual investor. This is because dividends paid to the corporation would benefit from the 50% (or greater) dividends received deduction, which would halve the tax rate paid by the corporation on dividends received to 10%.[18]

- **Transforming labor income into corporate profits.** Now take a step back and consider how the taxpayer earned the money available for investment. Here, too, a low corporate tax rate can be used to shield a portion of labor income from tax. Assume, for example that the taxpayer earns $1,000 of labor income. If the income is taxed at the top ordinary rate, the individual will only have $566 available to invest (after income, employment, and additional Medicare taxes). At the annual 2.26% individual after-tax rate of return described above, the income will grow to only approximately $708.

  If, however, the taxpayer's income is earned through a corporation, the same $1,000 of income will be taxed at a 20% rate, leaving $800 available for the corporation to invest.[19] At the annual 3.2% corporate after-tax rate of return described above, the income will grow to approximately $1,096. If that income is subject to a second layer of tax of 23.8%, that leaves $835—an 18% after-tax premium by using a corporation. The savings are supercharged if there is no second layer of tax—through a step up in basis (or keeping the corporate stock in a Roth as described below or the partial exclusion for gains on certain small business stock). In this case, the $1,096 faces no additional individual-level tax, and the taxpayer earned a premium of approximately 55% by both sheltering their labor

[17] ($1,370 – $1,250) / $1,250 = 9.5%
[18] This scenario is described by Daniel Hemel.
[19] A taxpayer would not be able to shield all of their labor income in this manner, but would be able to shield any amount in excess of reasonable compensation paid by the corporation to the taxpayer.

income and investing the after-tax proceeds through the corporation. Moreover, a corporation could deduct state and local taxes that an individual could not.

- **Salaries in a closely held corporation.** The tax advantage in this scenario is generally the same as in the examples above. The only difference in this case is that a taxpayer who is both a shareholder and employee of a closely held corporation does not need to go through the additional step of incorporating to shield a portion of their labor income. If the taxpayer earns a $1,000 salary from the corporation, this income is taxed at the ordinary rate, leaving only $566 available to invest. If, however, the taxpayer foregoes a portion of her salary in exchange for greater retained earnings at the corporate level, this amount is effectively taxed at the lower corporate rate (in the form of higher net corporate income). The corporation may then invest the after-tax amount of $800, which will similarly accrue at the corporation's higher after-tax rate of investment return—and with the total amount of savings depending on whether the second layer of tax is avoided or not.

- **Gaming retirement (and other ways to avoid the second layer of tax).** Finally, a taxpayer planning for retirement can achieve a result similar to the basis-step up scenario, without actually having to hold the corporate interest for her entire life. If the taxpayer in the previous example holds the corporate shares in a Roth account, then upon retirement the taxpayer pays no additional tax upon receipt of a distribution from the corporation, or upon a sale of the corporate interest. For example, assume that the taxpayer retires at the end of the ten-year period, when the $800 after-tax corporate investment has grown to $1,096. In this case, the total $296 of income may be distributed to the taxpayer tax-free, and labor income previously taxed at the low corporate rate also avoids the double level of tax. In effect, the taxpayer was able to use a combination of the Roth rules and the low corporate tax rate to shield the labor income from tax, invest this higher after-tax return at the lower rate, and then finally receive the final distribution tax-free. This strategy allows the taxpayer to make a Roth investment from pre-individual-tax, rather than after-tax dollars, and also to circumvent the limits on contribution to Roth accounts.

  A similar—though somewhat less favorable—result is accomplished outside the Roth context, if the taxpayer receives the distributions from the corporation after she is no longer working and has consequently moved into a lower bracket.

  Finally, there are other ways to avoid the second layer of tax on the corporate stock and, as a result, super-charge the tax savings. For instance, IRC 1202 provides for an at least partial exclusion of gain on certain "small business stock," again partially avoiding the second layer of tax.

Of course, as noted above in the main discussion, we do not suggest that taxpayers will be able to use these strategies without limit, and these transactions will be subject to judicial, statutory, and

regulatory anti-abuse rules.[20] But many of these anti-abuse rules rely on IRS action, and these doctrines have been relatively ineffective in the past.[21] Further, we expect that the resource-constrained IRS will face significant barriers to addressing all of these loopholes in the short term. We also expect that the proliferation of avoidance opportunities will lead to a further diversion of resources away from productive activity and towards tax planning.

More critically, these examples illustrate the general problem with reducing the corporate tax rate without making additional corollary changes to the structure of income tax, such as a transition to a system that taxes publicly traded corporations on a mark-to-market basis and others on a pass-through basis. A unilateral reduction in the corporate rate opens up new opportunities for tax planning, and is certain to result in additional and unanticipated revenue loss.

B. Pass-Through Eligibility Games

Both the Senate and House bills effectively provide lower tax rates to certain pass-through business income. The Senate does this by providing a 23% deduction for relevant income—essentially, lowering the top rate in the bill for applicable income from 38.5% to just under 30%. The House bill simply sets a 25% top rate on applicable income.

The two bills provide this benefit to certain pass-through business owners (but not to others) and not directly to employees. Here is some additional detail on the structures of these provisions:

- In both bills, certain activities face restrictions on availability of the preferential rate. Specifically, service providers in such fields as law and health cannot take advantage of the pass through rates in a number of circumstances—though the restrictions are gameable as described further below. In the House bill, there is a further limitation on any person who is actively involved in a trade or business (i.e. working at the firm), with the default being that only 30% of the person's income from the activity is eligible for the special low rate. In the Senate bill, the ability to take advantage of the lower pass-through rate is limited on the basis of the firm's W-2 wages. Specifically, the deduction is capped at 50% of the W-2 wages paid by the firm and allocable to the taxpayer. For example, if a firm has two equal-part owners and pays $1 million in wages, each owner's allocable portion of wages is $500,000 and her maximum deduction is $250,000.

[20] These may include judicial principles such as assignment of income and the economic substance doctrine, statutory provisions such as § 269A (personal services corporations), § 482 (allocation of income and deduction among taxpayers), § 531 (accumulated earnings tax), and § 542 (personal holding companies), and regulations that the IRS may promulgate pursuant to those provisions and the new tax legislation.

[21] Schler, *supra* note 1, at 3.

- In the Senate bill, the restrictions on the types of services eligible for the new deduction and the limit on the deduction to 50% of employee wages do not apply to sole proprietors, partners, and S-corporation shareholders with taxable income less than $500,000 for a married couple or $250,000 for an individual.

- In the House bill, the limitations on active involvement in the business and on services from specific fields can be waived on the basis of capital investment in the firm. Income that is essentially deemed to come from that capital investment is eligible for the pass-through rate. If a taxpayer is not in a restricted service sector, she would only take advantage of this exception to the degree the deemed income exceeds 30% of the total income (since this amount is automatically subject to the pass-through rate). Those in restricted service sectors can take advantage of this exception to the degree this income from capital investment exceeds 10% of total income.

- Employees do not benefit from the special pass-through rate on any of the income that they earn from that employment. The benefit is reserved for "owners," such as sole proprietors, partners, and S-corporation shareholders.

Based on these rules, certain groups seem to be clearly eligible for the preferential rate without much tax planning. For example, passive investors in firms receive the full benefit under both bills (assuming, under the Senate bill, the firm pays enough in employee wages).

However, other groups can plan their way into eligibility. And this planning could lead to much larger revenue loss than is now being assumed—especially if, under the Senate bill, the treatment of service providers in partnerships isn't clarified.

- **How employees could recharacterize themselves as "owners" under the Senate bill—and the legal ambiguity.**[22] The Senate rules can be read to allow service providers in partnerships to get the benefit of the pass-through deduction—so long as they are not receiving a "guaranteed payment" and so long as they are acting in their capacity as partners. If that is true, employers and employees should restructure so that employees can benefit from the lower pass-through rate, and even in fields that are subject to certain restrictions. (This game would work under the Senate bill but not under the House bill, since the latter applies its restriction based on capital investment.)

  This is the Law Firm Associates, LLC game described earlier. Yes, these associates provide services in law, but the restriction on activity only applies to those with income at or above $500,000 in taxable income for a married couple and $250,000 of taxable income for a single individual. Notably, many law firm associates make less than that. (And keep in mind, this is *taxable income*—after accounting for all deductions taken in

[22] Thanks to David Miller for this example. Mike Schler also discusses this in his forthcoming article.

translating gross into taxable income.) The associates couldn't be given a "guaranteed payment"—i.e. a guaranteed amount each year. Instead, compensation would have to depend in some way on the profits of Law Firm Associates LLC. But, associates shouldn't be too worried. The partners in the original firm can simply contract with Associates LLC to provide a steady stream of income.

Through this mechanism, firms—with sufficient sophistication and with employees with sufficiently high income that the tax savings are worth the trouble—can potentially transform employees into "owners" and thus make them eligible for the pass-through rate.[23]

The same may also be true of those who are characterized as "self-employed" sole proprietors (e.g. independent contractors) rather than employees. They too may be able to benefit from the pass through provision.

Importantly, this may not be the Senate's intent. Specifically, the Senate provision has a subsection governing "reasonable compensation" and "guaranteed payments." If these, along with payments to a partner not acting in her capacity as a partner, are received in exchange for services, they are not qualified income (i.e., not qualified for the pass-through deduction). Under current rules, it is easy in a partnership to avoid having a payment characterized as a guaranteed payment, and it is also easy to be found to be acting in the capacity of a partner (though Treasury could by regulation try to tighten that definition considerably). So, the key question under this Senate provision is whether a part of a partner's profit share received in exchange for services will be deemed "reasonable compensation" and thus not eligible for the pass-through deduction. And, for the self-employed, the question is whether their own business earnings would be subject to the same standard.

Past practice and part of the legislative history suggests the "reasonable compensation" standard would <u>not</u> apply at least to partnerships. Instead, this reasonable compensation standard has in the past only applied to corporations, requiring them to pay "reasonable compensation" to owners. By contrast, partnerships have been governed by the rules under IRC 707, requiring certain payments to be considered "guaranteed payments" and certain activities to be considered not acting in a capacity as a partner. But, those rules under IRC 707 would not—under current regulations—stop the kind of rearrangements we describe above from giving service providers the full benefit of the pass-through deduction. Further, the Joint Committee on Taxation's description of the Senate bill and

[23] This game—of becoming employees in a partnership—could also work for high income employees assuming their new "partnership" isn't providing a restricted service. However, you'd also have to give their new firm some employees to get them over the employee salary requirement—which applies to those over that $500,000/$250,000 threshold.)

the Senate Finance Committee's section-by-section analysis both state that the pass-through deduction is not available to "any amount paid by an S corporation that is treated as reasonable compensation"; neither document addresses amounts paid by partnerships or through sole proprietorships. Arguably, the "reasonable compensation" standard could be applied more broadly—and, if this were true, this loophole would be largely closed—but this would likely require regulatory action by the IRS (with only weeks remaining before the new legislation is likely to take effect) and the IRS action could be subject to challenge in court.

If Congress does not intend for this massive loophole in the Senate's pass-through provision, it must address this directly. It must make clear either in legislative history or, preferably, in the statute that partnership profit allocations would be recharacterized as wages and not eligible for the deduction to the degree they represent "reasonable compensation" for services—and it must make clear that the same is true of business earnings via a sole proprietorship. Congress cannot simply rely on the existing rules under IRC 707 if it wants to close this gap.

To be clear, the "reasonable compensation" standard is weak in itself. That too can be gamed and has been in the S-corporation context. It is surely better than nothing. A more comprehensive solution would require Congress or the IRS to promulgate much more detailed rules so that taxpayers can determine what portion of partnership income is reasonable compensation and what portion is eligible for the pass-through rate.

- **Under the House bill, go "passive" or add capital.** The House bill's restriction depends on capital investment. The key difference is that passive owners benefit from the full rate reduction, but active participants do not.

  Taxpayers therefore have an incentive to go passive if possible, or, if an active participant in a firm, to add capital in order to increase the benefit from the pass-through rate. As analysts like Dan Shaviro and Mike Schler have pointed out, the tax code's definition of passive activity was never intended to give people a benefit. It was designed to actually restrict loss taking and so hasn't faced pressure of people trying to fit in. This then leads to a number of the games already described above.

  Under the House legislation, you can also make a capital investment and take part of the benefit of the lower pass-through rate that way—and this particular game deserves additional explanation. As noted above, doctors and lawyers should own their own building. The rules provide a way for the income attributable to the building to get the lower pass-through rate. But, if the building is valuable enough, they could shield income beyond that—income from lawyering. The reason is that the provision assumes a very high rate of return from the capital investments, far above market rate (it assumes the

short-term rate plus seven percentage points). That then allows the building to shield income from services that otherwise wouldn't be eligible for the pass-through rate.

- **Avoiding the line of business restrictions: or how to be a top paid law partner or sports player and still benefit from the lower rates.** In the main text, we describe a number of games to play (with much thanks to Mike Schler for describing most of these)--such as setting up a separate company owning the brand. One issue deserves additional explanation here. Under the Senate bill, one barrier to a move like this—putting the brand name in a separate company to take advantage of the pass-through rate--is the restriction based on wages paid to employees. Specifically, the deduction cannot exceed 50% of the wages paid to the employees. However, even for extreme cases (like the famous sports player setting up a separate pass-through to manage the brand), there could be a work around. The player may not have many employees, but he could have one. Himself. The pass-through could be an S-corporation, and it could pay "reasonable compensation" to him, as required under the law. That reasonable compensation represents wages, and, thus, using the S-corporation, he can pay himself just enough wages to get the pass-through rate on a large portion of his income.

As noted in the main text, the first best solution to these problems is to drop the pass-through preferences entirely, but a second best solution would involve taking the time to substantially strengthen the guardrails as described there.

C. Restructuring State and Local Tax Deduction to Maintain Deductibility

Under both the House and Senate bills, the itemized deduction for state and local taxes for individuals is limited to $10,000 and only for property taxes. Non-income taxes[24] that are accrued in carrying on a trade or business, however, remain deductible for individuals. As noted earlier, states are likely to respond by shifting toward deductible taxes without changing significantly who pays the taxes as an economic matter. The following deductible taxes could all be used in place of nondeductible individual income taxes:

- **Property taxes.** States can shift to greater use of the property tax.[25] This will be easier in some states and localities than others. One common concern with the property tax is that it is not tied to "ability to pay," and thus can impose high costs on liquidity constrained

[24] There is some language in the current bills that suggests that income taxes are specifically not deductible by individuals, even if accrued in carrying on a trade or business. However, there is a strong argument, based on traditional income tax principles and other parts of the code that remain in force, that income taxes accrued in carrying on a trade or business (like the NYC Unincorporated Business Income Tax) remain deductible to individuals as well, as an "above-the-line" deduction. In any event, if income taxes were not to be deductible for an individual carrying on a trade or business, this would simply provide incentive for an individual no longer to carry on a trade or business as an individual.
[25] For further discussion, see Darien Shanske here.

taxpayers. There is a traditional response to this problem, which is to create a "circuit breaker"—a check on how high a percentage of a taxpayer's income can be used to pay property taxes. Circuit breakers are used in many states in one form or another. Many experts believe they should be used much more. The proposed changes to the SALT deduction would give states a significant incentive to utilize large and generous circuit breakers in order to encourage greater use of deductible property taxes. The circuit breaker could even be designed to kick in when property taxes paid exceed roughly the percent of income a taxpayer paid before the repeal of the SALT deduction. Most states have income taxes and so regularly collect all the information that they need to administer a large circuit breaker. Also, given that most tax returns—certainly itemized tax returns—are likely to be prepared by an expert and/or by means of automation, additional complexity, such as taking into account the percentage of property taxes paid before tax reform, ought to be achievable.

There would be coordination issues of course. For instance, local property taxes are collected at different times than state income taxes. Yet this problem is solvable given that state legislatures typically control the timing of the collection of both taxes. States and localities also regularly borrow in anticipation of tax revenue should such a structure create liquidity problems for a government.

This particular expedient is limited. It would only help itemizers who currently do not deduct $10,000 in property taxes, but do have other taxes to deduct. What this expedient would do is make certain that any itemizer with $10,000 or more in state and local property and income taxes will get to deduct at least $10,000, even if the property tax component is less than $10,000. The amount of revenue this would cost the federal government could be quite significant.

- **Employee payroll taxes**. Neither the House nor Senate bill eliminates the ability of businesses to deduct their taxes. This makes sense as these taxes are an ordinary and necessary business expense. Yet opening up a chasm between deductible business taxes and nondeductible individual taxes invites states to shift from one form of revenue collection to the other. Indeed, several states, particularly states without an income tax, have experimented with new business level taxes recently. As with property taxes, states need not engage in fundamental fiscal reform. Rather, states could seek to increase the deductibility of their taxes by means of increasing taxes whose incidence is expected to remain on the individual. For example, a state could reduce its personal income tax, but impose/increase a state payroll tax with legal incidence on the employer.[26] Since the tax is levied on the employer, the employer would still be able to deduct the taxes—even as it would function, in economic terms, very similarly to an income tax imposed directly on the employee. The result would be a reduction in wages (to pay the tax), and that

[26] For further discussion, see Daniel Hemel here.

reduction in wages (basically, paying the tax) would essentially be deductible against federal income taxes—since it reduces AGI.

It is worth noting that state income taxes are often less progressive than federal income taxes and so the amount of substitution toward a flat rate payroll tax could be very large. Even a relatively progressive tax structure has rates at the bottom that could be wholly replaced by a payroll tax, and the system as a whole could maintain (or enhance) current progressivity by combining an increased payroll tax with refundable tax credits provided directly to workers through the individual income tax system.

Imposing such a payroll tax would be fairly straightforward for a state to administer, even for states without an income tax. This is because employers already have to pay payroll taxes on their employees' wages to fund unemployment insurance. A system of refundable credits might be more complicated, but some states already have smaller credit systems (via state EITCs) in place.

Shifting to payroll taxes in this way, if a large enough trend, could wipe out all savings from repeal of the SALT deduction—and then some. This is because most taxpayers do not itemize, but this strategy, in effect, could make a sizable portion of *all* current state income taxes deductible.

- **Charitable gifts.** Neither the House nor Senate bill repeals the charitable deduction. Donations to state and local governments are generally deductible. Thus charitable donations offer another substitute for the state and local tax deduction.[27] A $10,000 gift to one's local school district reduces one's federal taxes just as much as $10,000 in local property or income taxes. Once again, the question is how to transform the $10,000 that is currently raised in non-deductible taxes into $10,000 raised in deductible charitable donations. The answer, much as with the other examples, is for states with an individual income tax to offer a tax credit for charitable donations made to state and local governments or specific parts of state and local governments. There is substantial authority that the credit can be as high as 100%, while preserving the charitable deduction (and despite the apparent quid pro quo), because states do offer such credits for tuition at tax-exempt private schools. Given the changes that the Senate bill makes to 529 plans in connection with spending on private school tuition, it would be incongruous for these credit regimes to be upended. The repeal of the SALT deduction is therefore an invitation for many more states to offer these plans and to make them quite generous.

- **Business "franchise" taxes on pass-throughs.** As explained above, the current bills are designed to benefit taxpayers who earn income through pass-throughs and, in all likelihood, will provide benefits to such taxpayers far beyond what has been anticipated.

[27] For further discussion, see Manoj Viswanathan here.

States can seek to recapture some of this benefit by imposing (or encouraging local governments to impose) business "franchise" taxes—taxes imposed on the business entity. Such taxes appear to remain deductible even if imposed on "pass-throughs" (and so ultimately deducted by the individual). That is because both bills would maintain the deduction for taxes accrued in carrying on a trade or business or investment—though potentially not income taxes accrued by individuals. As a result, most franchise taxes would seem to remain deductible. This is a sensible result to the extent that states have a legitimate interest in taxing business entities based on how profitable or valuable they are. Current versions of these taxes are sometimes based on the capital or net worth of the firm, or, in the case of NYC, the income of the firm. We could envision challenges to deducting some of these taxes (specifically those based explicitly on business income) in the pass-through context, but we are fairly certain that at least some forms of these taxes would remain deductible even if imposed on pass-throughs. Once a form of tax is shown to be successful, then we would expect it to be emulated.

As with the property tax, states could mitigate the possible burden of such business taxes on individual owners with modest or even higher incomes by linking these taxes up to their individual income tax systems—for instance, by reducing individual income tax liability based on franchise tax payments.

As we discussed in the main text, we do not think there are any straightforward fixes here. The various substitutes and expedients have long pedigrees and their own policy rationales. The key legal doctrines, such as the use of legal incidence, are crucial for the functioning of our tax system overall. Finally, the cost to the states of instituting these changes relative to the potential gains is small. As described in greater detail in the main text, the three options we see are: 1) reduce or eliminate the cutback; 2) use a realistic revenue estimate if the current cap is retained; or 3) broaden the scope of taxes that can be deducted and phase-in a higher cap.

D. International Games, Roadblocks, and Glitches

1. Problems with the Minimum Tax on Intangible Income

The Senate and House bills impose a minimum tax on intangible income (the GILTI regime in the Senate and the high profit foreign-subsidiary regime in the House). The tax base for the minimum tax is calculated by taking the income of the controlled foreign corporation and subtracting out a routine rate of return on the tax basis of the corporation's tangible property.

The following points elaborate further on problems discussed above in the main text:

- **The minimum tax on intangible income can be avoided through leverage.**[28] Firms can use leverage to create basis in tangible assets, wiping out their minimum tax liability on intangible income. Because borrowed funds increase basis in assets, a firm can use the leverage to shield the intangible income, engaging in a type of tax arbitrage since the interest expense will also be deductible.

- **The minimum tax formula induces companies to locate real assets offshore.** In addition to the incentives discussed in the main text, the minimum tax rate effectively encourages firms to locate manufacturing subsidiaries (and manufacturing jobs) in low-tax foreign countries (instead of the U.S.) and then having those subsidiaries sell their products back into the United States (and other market countries). Such sales would be subject to 10% taxation, whereas firms would face a 20% tax on U.S. sales if done through a U.S. manufacturer (and, under the Senate bill, a 12.5% rate on export subsidies through the FDII regime, which is discussed below).[29]

- **The global approach to the minimum tax induces companies to locate investment offshore.** In both bills, the minimum tax is calculated on a global basis. This incentivizes firms to shift investment offshore in order to blend low- or zero-taxed income from tax havens with income from higher-tax foreign countries, thus avoiding the minimum tax altogether. For instance, say a corporation earns $100 of income in Country A, which is taxed locally at a 20% rate. Additional income of $100 in the United States would be taxed at the new corporate rate of 20%, for a total tax liability of $40 ($20 to Country A and $20 to the United States). If the income was instead earned in a tax haven, Country B, which taxes the income at a 0% rate, total foreign taxes imposed would be $20 (Country A taxes), 80% of which ($16) are creditable against the 10% minimum tax imposed by the United States. The 10% minimum tax thus produces a U.S. tax liability of $4 [(10% × $200) – 16], thus bringing down the total tax liability (both foreign and domestic) to $24 (as opposed to $40 if the additional investment was located in the United States).

Further discussion of the solutions described above in the main text:

- A partial solution would be to limit the ability to use leverage to create tangible asset basis that shields income from the minimum tax. Interest expense could be netted from the deemed rate of return, but this approach could preserve an arbitrage opportunity between the actual interest expense and the high 10% deemed rate of return. Conversely, the debt principal could reduce the tangible asset basis, but this could overly penalize

[28] The leveraging strategy comes from analysis done by Mike Schler and Mitchell Kane. Schler, *supra* note 1, at 44; Email from Mitchell Kane to David Kamin and Ari Glogower (Dec. 4, 2017).
[29] Thanks to Cliff Fleming for this point. Also, this scenario is inspired by correspondence with Steve Shay.

non-abusive debt-financed businesses, and bring all debt-financed tangible assets into the GILTI tax base.[30]

- Alternatively, one could ignore debt and instead exempt an amount equal to a risk-free rate of return to the equity in each CFC. If one does not limit the ability to use leverage, then at the very least the 10% deemed return on tangible asset basis could be set at a lower percentage rate.
- More comprehensive solutions are discussed above in the main body.

2. Problems with the Reduced Rate on Foreign-Derived Intangible Income (FDII)

The Senate bill allows for a 37.5% deduction for foreign-derived intangible income (FDII), thus effectively subjecting such income to a favored 12.5% rate. The way that it is calculated means that the greater the U.S. taxpayer's income from exports, the more of its income gets taxed at the 12.5% rate.

Further discussion of problems:

- **The reduced rate on foreign derived intangible income can be gamed through resale transactions.** Goods sold for foreign use generate income, a portion of which gets the 12.5% FDII rate. Goods sold for domestic use do not get the favored rate. There is currently no mechanism that differentiates goods sold for foreign use from goods sold for domestic use. Without anti-abuse rules, taxpayers will structure transactions to sell goods abroad and have them resold back into the United States in so-called "roundtripping" transactions, thus taking advantage of the FDII rate. Domestic corporations could even sell to technically independent foreign distributors who resell into the U.S. but then impose advertising and marketing requirements and price restrictions upon those distributors. This approach would give the domestic corporation substantial control without violating the technical independence of the distributors. Although the bill provides that the taxpayer has to establish to the satisfaction of the Treasury Secretary that the goods are sold for use abroad, taxpayers will take the position that the intent for an initial sale to a foreign business is sufficient (like in a VAT regime).

- **The reduced rate on foreign derived intangible income likely violates WTO obligations.** The way FDII is calculated means that the greater the U.S. taxpayer's income from exports, the more of its income gets taxed at the 12.5% rate (instead of the 20% rate). As such, it is likely an illegal export subsidy in violation of our WTO obligations (specifically, Articles 3.1(a) and 3.2 of the Agreement on Subsidies and Countervailing Measures and Article III:4 of the GATT 1994).[31] This threatens to revive a three decades-long controversy over export subsidies that was thought to have been put

[30] This analysis was provided by Mitchell Kane.
[31] For further discussion, see Rebecca Kysar here.

to rest in 2004 with the repeal of the extraterritorial income regime. Although the United States may argue that intangible income lies outside the scope of the WTO agreements, in the bill, the intangible income is simply a deemed portion of the income from the sale of tangible goods. Exports of tangible goods are clearly covered by the agreements, and thus the FDII rate will almost certainly fall within their scope. Given its uncertain legal status, firms will not be able to rely upon the change and will continue to locate IP offshore.

- **The reduced rate on foreign derived intangible income is available to firms that have zero manufacturing or employees in the united states and induces firms to sell to foreign manufacturers rather than domestic.** Firms can obtain the lower FDII rate while having zero manufacturing or employees in the United States—buying goods from a foreign supplier for resale abroad is sufficient.[32] Perversely, the FDII rate also incentivizes firms to sell to foreign manufacturers rather than domestic manufacturers. This is because a U.S. firm will be unable to obtain the FDII rate when it sells unfinished goods to an unrelated U.S. manufacturer (since this qualifies as a domestic sale) but will be able to obtain the FDII rate when it sells unfinished goods to a related or unrelated foreign manufacturer (since this qualifies as an export).

Further discussion of the solutions:

- As discussed in the main text, we recommend jettisoning the FDII regime. If it is retained, we recommend neutralizing the rates on FDII and GILTI to avoid taxing the export income more heavily than the foreign intangible income (an undesirable result given the aims of the reform to bring investment home). One possible justification for a lower GILTI rate is the reduction of foreign tax credits in that regime, but if there are no foreign taxes paid (e.g. in tax havens) then the lower GILTI rate is a windfall.

3. Problems with the Inbound Provisions

The bills impose additional tax liability on deductible payments from certain corporations to foreign related persons through two different mechanisms (Base-Erosion Anti-Abuse Tax (BEAT), in the Senate, and the excise tax, in the House).

Further discussion of problems:

- **BEAT likely violates WTO obligations and presents tax treaty concerns.** The Senate bill imposes BEAT on deductible payments from certain corporations to foreign related persons. BEAT does this by adding back certain related party payments and imposing additional tax liability on this expanded base, effectively ensuring that at least 10% tax is imposed on such income. The BEAT presents WTO problems, and will likely be

[32] This observation is from Mike Schler. Schler, *supra* note 1, at 40-41.

characterized by our trading partners as a forbidden charge on importation (General Agreement on Tariffs and Trade II section 1(b)) or a discriminatory internal tax (General Agreement on Tariffs and Trade III section 2). Although strengthening inbound taxation is a worthy goal, the United States should anticipate WTO litigation.

Although the Senate bill appears to be designed to avoid explicit overrides of our bilateral tax treaty obligations by imposing the tax on the U.S. entity and by not denying deductions or imposing withholding tax (unlike the House's counterpart, the excise tax), our treaty partners will likely still view BEAT as violating the nondiscrimination requirement in the treaties (Article 24).[33]

- **The excise tax likely violates WTO obligations and tax treaty obligations.** The House bill imposes a 20% excise tax on certain payments made by a U.S. corporation to its foreign affiliates. The recipient may elect out of the excise tax by treating such payments as effectively connected with a U.S. trade or business. If such election is made, the House bill then applies the 20% corporate rate to a deemed measure of net income on such related party payments. Like its Senate counterpart (BEAT), the excise tax also presents WTO concerns as a forbidden charge on importation or a discriminatory internal tax.

  Because of its mechanics, the excise tax also likely abrogates our bilateral tax treaties by effectively imposing a withholding tax on royalties (Article 9) and by undermining the treaties' arms' length principle (Article 12), permanent establishment (Article 7), and nondiscrimination (Article 24) requirements.

[33] Reuven S. Avi-Yonah, *Guilty as Charged: Reflections on TRA 17*, Tax Notes 1131, 1135 (Nov. 20, 2017).