The Games They Will Play:
An Update on the Conference Committee Tax Bill

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As with our previous joint report, this update 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.

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I. Introduction

Earlier this month, we posted a report identifying key weaknesses in the Senate and House tax bills.[1] Unfortunately, many of the same basic weaknesses still exist in the newly released conference bill (also known as the Tax Cuts and Jobs Act or TCJA). While some issues were addressed, others were made worse, and the new bill introduces fundamental—and in our view insurmountable—structural problems to the income tax.

The legislation is still likely to cost more than the current estimates of over $1 trillion, to advantage the well-advised (and their advisors) in ways that are both deliberate and inadvertent, and to face legal roadblocks like WTO non-compliance that could undermine key components of the legislation. Finally, the bill includes glitches that could lead to haphazard and unexpected results that could arbitrarily favor or penalize taxpayers.

The most serious structural problems with the bill are unavoidable outcomes of Congress's choice to preference certain taxpayers and activities while disfavoring others—and for no discernible policy rationale. These haphazard lines are fundamentally unfair and inefficient, and invite tax planning by sophisticated taxpayers to get within the preferred categories. It's a substantial blow to the basic integrity of the income tax.[2]

These problems will only be substantially addressed by fundamentally changing or rolling back the relevant provisions. In several cases, as we describe, forward-leaning IRS action will be key to stanch the bleeding—however, such action will require leadership from the Trump administration and will be hindered by the years of budget cuts that have hit the IRS.

In other cases—and in particular, when it comes to the deduction for state and local taxes—some of us view state and local responses to avoid the limitation as expected and justifiable. Such moves, however, would entail considerable additional costs to the federal Treasury that have not been accounted for in revenue estimates of the bill.

The Conference Committee released its legislation last Friday evening, and the conference bill is expected to receive a vote in the coming week in both the Senate and the House. A comprehensive analysis of the new provisions—and how they've changed from the prior bills—is not possible within such a condensed time frame. However, with votes scheduled for this week, we offer an update of our report, based on our analysis over the weekend and on commentary from other tax experts. In fact, the questions we have about the basic working of

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[1] Avi-Yonah et al., The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation (Dec. 7, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084187 [hereinafter "The Games They Will Play"].

[2] For a description of the conference bill's disregard for the basic principles of income taxation, see Daniel Shaviro, Apparently Income Isn't Just Income Anymore, Start Making Sense (Dec. 16, 2017), https://danshaviro.blogspot.de/2017/12/apparently-income-isnt-just-income-any.html.

key provisions—including new ones just introduced—demonstrate the irresponsibility of moving so quickly to a vote on this legislation.

Specifically, the conference bill allows for the following basic planning opportunities:

- **Using corporations as tax shelters.** C-corporations will be used to shelter income from the top ordinary income rate, with no further protections added to the bill to avoid this outcome. As we described in our prior report, the use of corporations as tax shelters can result in labor income only being taxed at the preferential 21% rate, and entirely eliminate the "second layer" of tax when an individual receives a dividend or sells the corporate stock (for example, through the through step-up in basis at death). The incentive to use corporations as tax shelters is slightly reduced under the conference bill relative to the prior version as a result of the slightly higher corporate rate and lower top individual rate, but the tax savings could still be considerable. Pre-existing safeguards to avoid these kinds of consequences are already inadequate and will be even more so in light of the planning incentives that this rate differential creates.

- **Pass-through games.** The conference bill will allow well-advised taxpayers to circumvent the limitations on eligibility for the special tax treatment of pass-through businesses. The pass-through provision allows eligible taxpayers to reduce their taxable business income by 20%, and the complex rules involved will invite plenty of gaming opportunities. There is no particular logic to who clearly fits into the preferred categories, and the game will be to get within the haphazard lines.

  In fact, the conference bill, while adopting much of the Senate's proposal, worsens matters along an important dimension. The conference bill allows owners of firms with no wages whatsoever, and just certain kinds of property, to take advantage of the lower rate. This change both expands the availability of the pass-through deduction and encourages firms to game the rule by increasing their ownership of qualifying property (for example, by owning instead of leasing)— and possibly even by replacing workers in the process.

  Further, service providers will be able to take a number of steps to try to qualify for the pass-through deduction. Any married employee with taxable income less than $315,000—a lower threshold than set initially in the Senate bill but still high enough to cover many highly paid professionals—will have an incentive to be a partner or an independent contractor rather than employee, and appear to get the full benefit in that case. Higher-income law partners, doctors and other professionals will likely be able to engage in strategies to access the special rates, such as buying their buildings and owning them in a separate entity, or going in-house at firms that are not in restricted fields. The IRS should try to restrict these opportunities, but the agency will be constantly challenged

as a result of its lack of resources, the ambiguous lines that are drawn, the lack of principle underlying those lines, and the tax benefits at stake.

Finally, in another important loophole, pass-throughs may be able to largely bypass the new limitation on interest expense, and public corporations can then use pass-through subsidiaries to do the same. Similarly, public corporations can potentially even avoid the 162(m) provision restricting the deductibility of compensation for highly paid executives by again using a pass-through subsidiary.

- **Restructuring state and local taxes (SALT) to maintain deductibility.** The conference bill permits states to pursue three of the four strategies we outlined in our previous report to avoid the $10,000 cap set by the bill, and to preserve the deductibility of state and local taxes beyond this amount. All three strategies rely on replacing state taxes that are no longer deductible over this cap with other taxes or sources of revenue (such as charitable donations or employer-side payroll or franchise taxes) that will remain deductible.

- **International games, roadblocks, and glitches.** The conference bill will invite a variety of tax planning and avoidance opportunities for taxpayers with international operations. For instance, taxpayers may seek to claim the lower export rate when they sell products abroad even when those products are sold right back into the United States.

  Furthermore, the World Trade Organization problems we described in the initial report still remain, especially with regard to the lower rate on exports. The obstacles under our system of bilateral income tax treaties have been alleviated to a degree since the Conference Committee chose the inbound Senate provisions over the more troublesome House provisions, although this issue is by no means resolved. Very little has been done to alleviate the perverse incentives created by the new system to offshore real business operations and income.

Part II of this report update describes in greater detail these games, roadblocks, and glitches arising from the conference bill. Part III follows with an agenda for future work by the IRS and Congress to protect the integrity of the tax system if the conference bill is passed this week.

II. An Update: Tax Games, Roadblocks, and Glitches

A. Using Corporations as Tax Shelters

The conference bill taxes C-corporations at a 21% rate beginning in 2018. As a result, taxpayers would still be able to use corporations as tax-preferred savings vehicles through the strategies described in our prior report. The conference bill does not strengthen in any way the anti-abuse rules that would be necessary to prevent these games, and that are inadequate under current law, even as the pressure on these rules will dramatically increase.[3]

The slight uptick in the corporate tax rate (from the 20% proposed in the House and Senate bills) coupled with the slight decrease in the top statutory rate on ordinary income (from 39.6% to 37%) would reduce the benefit from using corporations as tax shelters on the margins, but would not significantly affect the calculus for taxpayers seeking to shield their labor and investment income from the higher individual rates,[4] particularly since individuals cannot deduct state and local taxes, but corporations can.[5] The rate disparity between individual and ordinary income will put much larger pressure on the system than under current law, where the rates are much closer to each other (a 35% top corporate rate versus an individual rate of about 40%).

For greater detail on the specifics of the following games, see the discussion in our prior report at Part II.A and the Appendix.[6]

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[3] In particular, these include judicial principles such as assignment of income and the economic substance doctrine, the possible recharacterization of undistributed profits as salary, 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). As we note in our prior report, these anti-abuse rules could discourage the most severe abuses, but are notoriously porous and easy to evade, and would be difficult for a resource-constrained IRS to enforce. See The Games They Will Play, *supra* note 1, at 7 n. 1.

[4] For example, consider the effect of these rules in the "Stuffing the C Corp" example below. Assume that a taxpayer has a bond that pays $100 of interest income. At a top individual rate of 40.8% (37% plus 3.8% NIT), the individual would pay $40.80 of tax in the current year, and would be left with $59.20. If the same bond is held by a corporation, the corporation would pay only $21 of tax in the current year. If the corporation distributed the remaining $79 to the taxpayer immediately, the taxpayer would pay an additional individual-level tax of $18.80 (23.8% of the $79), and would be left with $60.20. The benefit of holding the bond through the corporation will increase, however, if the taxpayer is able to keep the bond in the corporation for longer, and thereby defer the individual-level tax.

[5] For example, if the individual in the prior example was a California resident in the highest bracket, he or she would pay an additional $13.30 in state taxes, for total taxes of $54.10, and would be left with $45.90. The corporation would pay $8.84 in California taxes, but could deduct the state taxes from its federal taxes and pay $19.14 in federal taxes or $27.98 total, and would be left with $72.02, $26.12 more than the individual. This difference of $26.12 is $6.32 more than the $19.80 in the prior example.

[6] See also Shawn Bayern, An Unintended Consequence of Reducing the Corporate Tax Rate, 157 Tax Notes 1137 (Nov. 20, 2017); Michael L. Schler, Reflections on the Pending Tax Cut and Jobs Act, 157 *Tax Notes* 1731 (Dec. 18, 2017); 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/. For formative works on the use of a C-corporation as a tax shelter, see generally Steven A. Bank, From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present (2010); Edward

- **Stuffing the C-corp.** The simplest strategy is for a taxpayer to invest through a corporation, so her investment income is taxed at the lower corporate rate. This strategy is most beneficial with respect to fixed-income investments generating ordinary income, but would also be available for domestic equity investments that pay dividends, because dividends received by the shelter corporation would benefit from the 50% dividends received deduction.

- **You, Inc.** Taxpayers will be able to shield their labor income from tax by simply setting up a corporation and having their income accrue in the form of corporate profits. As a result, income that would have been taxed at the high individual rates is instead taxed at the low corporate rate (in addition to avoiding employment taxes as is commonly done today). As described in our prior report, current law is inadequate to effectively police this game.

  There is really no downside to this game, since the "double tax" on both corporate and individual earnings is less than the top individual rate. And if a taxpayer changes their mind at any time, they can simply convert their C-Corp to an S-Corp that is taxed as a pass-through.

- **Salaries in closely-held corporations.** For the same reason, shareholder-employees in closely-held corporations can reduce their wages paid out by the firm, and through this strategy can increase the corporation's more lightly-taxed profits.

- **Avoiding the second layer of tax.** The games above describe opportunities to shield both labor and investment income from tax by using corporations as tax shelters. Of course, corporate profits will be taxed too at the individual level when distributed out as dividends or when the stock is sold. Taxpayers can use a corporation, however, to super-charge their tax gaming and completely avoid this individual level of tax through a variety of strategies:

  - **Step-up in basis.** If a taxpayer holds her interest in the corporation for her entire life and the corporation does not pay dividends, the individual level tax on the corporate profits is completely eliminated due to the "step-up" in basis.

  - **Roth retirement accounts.** If a taxpayer holds her shares in the corporation through a Roth retirement account, the individual level tax is completely forgiven. This strategy will be most beneficial for a taxpayer who holds shares in a closely-held corporation in her Roth account.

Kleinbard, "Corporate Capital and Labor Stuffing in the New Tax Rate Environment" (March 21, 2013), https://ssrn.com/abstract=2239360.

- **Lower tax rates in retirement.** A taxpayer can wait to receive a distribution of corporate profits in a year when she does not have other taxable income, and will be taxed at a low rate on corporate profits that were earned in prior periods (when the taxpayer might have been taxed at a much higher rate).

- **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.

B. Pass-Through Games

The conference bill grants a 20% deduction for certain qualified business income, which in effect reduces the top tax rate from 37% to 29.6%. The amount of the deduction is reduced slightly from the 23% in the original Senate bill, but still provides a tremendous incentive for taxpayers to shoehorn their income into the "qualified" category. Some of the games we discussed in our initial report have been restricted—but much mischief remains that could be played, and some entirely new games have been introduced.

A significant (and surprising to many analysts) giveaway in the conference bill weakens the requirement for high-income owners to pay employee wages to be eligible relative to what was in the original Senate bill. The provision otherwise largely follows what was in the Senate legislation. This addition will expand the ability of highly paid owners in certain industries—and particularly those heavy in property but light in employees, like real estate—to qualify for the pass-through deduction.

For more background on the relevant provisions in the conference bill, see the Appendix. For more detail on the basic planning games described here, see the discussion in our prior report at Section II.B. and the Appendix.

The heart of the problem is the absence of a policy justification for the deduction; it draws formalistic lines favoring some groups and industries but not others, some of whom benefit and others who do not. And those are lines across which taxpayers will play.[7]

- **Sitting at the center of the loophole.** Some people reap the pass-through windfall without the need for games. For them, the only game is to be themselves. This category includes owners of firms that don't provide listed, "disfavored" services, or owners of firms that provide "favored" services, or owners of forms that provide any services but with low enough incomes.

[7] As before, we are grateful to Mike Schler for his many insights on the pass-through games. *See* Schler, *supra* note 6, at 1734-1741.

Some professionals, such as architects and engineers, have been moved in the conference bill from the "disfavored service" category to the "favored service" category. As a result, they are now most likely excepted from some restrictions on service providers, and so can be very highly paid and still get a partial or full deduction.[8] There is no clear policy explanation for why these services are "favored" services, while, say, doctors or those in the performing arts are still in the "disfavored" category.

And, as discussed above, owners of firms in "favored" businesses paying no wages whatsoever can now benefit from the special deduction. Whereas the previous Senate bill restricted the benefit to owners of firms that paid W-2 wages, the new bill extends the benefit to firms that don't pay wages but that own and use depreciable tangible property (like buildings or automated machines that replaced their employees). Moreover, the benefit is based on the original undepreciated cost of the property, and lasts for the greater of 10 years or the normal depreciable life of the property. Real estate firms with high original basis and few employees should be able to more easily access the preferential rate (adding to another loophole that already gave real estate firms preferential treatment), and the same is true of other industries with similar profiles.

The games then come about for those who aren't yet among the favored, but can use various strategies to join their ranks.

- **John Doe, independent contractor (or partner)—but definitely not an employee.** The pass-through deduction is still denied to anyone who is an employee. This is good news to anyone who can quit their job and become an independent contractor (and so considered a "sole proprietor") or a partner in a firm. The game is clear: Don't be an employee, instead be an independent contractor or partner in a firm. Don't be John Doe, employee. Be John Doe, independent contractor (or partner in an LLC, receiving a profit share rather than wages).

  Individuals who provide "specified services" (such as lawyers and doctors) must have taxable income of less than $315,000 for a married couple (or half that for a single individual) to be fully eligible—with the benefit phasing down over the next $100,000.

[8] The status of engineers and architects under the new section 199A, providing for the 20% deduction, is somewhat murky. The House and Senate versions included (by way of cross-reference to section 1202(e)(3)) a list of *per se* specified service trades or businesses whose eligibility for the special rate would be limited (Senate version) or eliminated (House version). The conference report removes engineering and architecture from that list (which now include health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services). However, the definition of specified service trades or businesses in the conference report still includes (via cross-reference) "any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees." As that catch-all phrase would seem to capture most engineering and architecture businesses, the removal of engineering and architecture from the list of *per se* specified services may prove to be futile. Much will depend on how the IRS and the courts interpret the new language. In any event, engineers and architects still will be subject to the provision that caps qualified business income on the basis of W-2 wages and/or capital investment.

But keep in mind, taxable income is calculated *after* taking into account other deductions, like the standard deduction or itemized deductions. As a result, individuals with even more actual economic income could still fully qualify for the deduction.

Originally, we had described this game as the Law Firm Associates, LLC loophole. Given the new income restrictions, it probably won't as broadly cover the highest paid law firm associates, but it still should apply to plenty—who will all be incentivized to form their own separate Associates, LLC firm. For instance, median base salary for a fourth year associate this year was $155,000,[9] an income level that would still qualify for the pass-through deduction.

The technique would also apply, without any income limit, to any "favored" business—like real estate—that is willing to turn an employee into a junior partner in the business. That is so long as the business pays sufficient W-2 wages or has enough original tax basis in depreciable property.

The bottom line is that these techniques will cover a wide swath of relatively high-income people who are now employees. The IRS already faces challenges enforcing the tax distinction between employees and independent contractors (since employers already have some incentive to characterize workers as independent contractors),[10] and this pressure will increase hugely with the added tax gaming incentives. And, if an employee can't easily be recharacterized as an independent contractor, they can always become a partner to access the preferential treatment.[11]

- **Doctors and lawyers are now in the real estate business, and celebrities should sell face cream.** The highest paid doctors and lawyers (and those in other professions that are specifically listed) would not be directly eligible for the 20% write off since they are in restricted "specified service" industries, which covers certain listed professionals above the income threshold. Other professionals who are not on the list are also denied the pass-through deduction if the "principal asset" of the business is their "reputation or skill." This category could affect celebrities and other public figures.

[9] See Sarah Ramirez, NALP, Associate Salaries Rise in Some Market, But National Median Remains Unchanged (June 1, 2017), https://www.nalp.org/uploads/Research/AssociateSalarySurveyReportPressRelease.pdf.

[10] For the basic difficulties in distinguishing between employees and independent contractors for tax purposes, see David A. Weisbach, Line Drawing Doctrine and Efficiency in the Tax Law, 84 Cornell L. Rev. 1627, 1632 (1999).

[11] The IRS might try to restrict this game of simply recharacterizing employees as independent contractors or partners by arguing that the deduction does not apply to the degree that profits represent "reasonable compensation" for services. They'd have at least some statutory support for doing so. *See* IRC 199A(c)(4). However, as we explained in the Appendix to our last report, the legislative history suggests that the "reasonable compensation" restriction applies only in the case of S-Corporations (and not partnerships or sole proprietors), with other easily gamed restrictions (under IRC 707) applying to partnerships and maybe no such restrictions at all applying to sole proprietorships.

Restricted professionals can potentially still game these rules through two basic strategies. To borrow from the terminology of gerrymandering strategies, let's call them "cracking" and "packing."

- **Cracking.** The first strategy is to "crack" apart the revenue streams from the service partnership, so as much income as possible can qualify for the deduction. This is probably the preferred route for those in the "listed" professions.

  To do this, doctors and lawyers (and others listed professionals) would set up separate companies. As Victor Fleischer has pointed out, the ideal arrangement from a tax avoidance perspective would involve a real estate investment trust (REIT), which is automatically eligible for the pass-through rate, without any requirement that the REIT pay W-2 wages.[12] (This is the other big real estate loophole.) Then, the REIT should charge the law firm the maximum rent they can get away with in order to qualify some of the service income for the pass-through rate. The REIT strategy is limited by the fact that REITs must have at least 100 beneficial owners,[13] but there are currently ways of adding additional owners with relative ease and giving them only a very small share of any profits.[14]

  Similarly, doctors and lawyers might try to form separate firms owning ancillary services that aren't providing the forbidden kinds of services. That includes firms handling their accounting, document management, software, and so on. Again, the game would be to essentially overcharge the main firm for these ancillary services—though, unlike with the REIT, this game would immediately be restricted by the need to pay sufficient W-2 wages from the new businesses.

  The IRS can and should try to crack down on these kinds of arrangements in at least two ways. First, the IRS could seek to apply rules similar to those used to define personal service corporations under existing law. Under those rules, the performance of administrative and support functions incident to a service trade or business are considered to be part of the performance of the service trade or business.[15] (This approach would most easily reach the ancillary services described above, but probably not the separate real estate firm.) Second, the IRS could try to attack the mispricing that could strip income out of the service firms. However, these kinds of transfer pricing games among related parties have proven very difficult to stamp out in other contexts.

[12] Victor Fleischer first described something like this arrangement here: https://twitter.com/vicfleischer/status/926294879998758912

[13] § 856(a)(5).

[14] A typical private REIT will hire a service to find it 100 preferred shareholders who each will pay $1,000 and receive a 10% annual return. That comes at a $10,000 annual cost, but that is relatively small as compared to potential tax savings.

[15] Temp. Treas. Reg. § 1.448-1T.

- **Packing.** The second strategy is to "pack" other qualifying businesses into the service partnership, to transform the combined entity into one that is not primarily providing services.[16] The IRS may be able to attack this strategy in the case of listed professionals (and we encourage the IRS to do so quickly) but would have a harder time dealing with other professionals who blend their reputation or skill with other business activities. As a result, "packing" will be particularly advantageous to taxpayers in this category.

  Here's the form that may be hardest for the IRS to attack: Non-listed professionals blending their reputation or skill with other businesses. For example, say you're Gwyneth Paltrow, a celebrity with a generally positive reputation. Now consider her "lifestyle brand" goop, which sells $125 face creams, among other products. Does goop rely too much on Paltrow's reputation, or is it just another business? A business like this (if it were not incorporated, as is the case with goop) would almost certainly qualify for the special pass-through deduction, notwithstanding the centrality of the owner's reputation. We would expect to see more goop-like business to appear. It's not just Gwyneth Paltrow. Imagine a certain real estate mogul and reality TV start who might want to combine a business based on his reputation (and associated licensing deals) with real estate investments.[17] Once the business operations are packed together, it would be harder for the IRS to argue that reputation is still the principal asset.

  For listed professionals (lawyers, doctors, and others), the availability of the packing strategy is more complicated. First, there is a question whether provision of *any* forbidden service to customers means that the entire trade or business cannot qualify for the deduction, even if it includes qualifying activities as well. If it does, then packing won't work—they're stuck with cracking. But, if the IRS were to allow provision of qualifying services to cleanse the operation, then you can expect similar games. Real estate lawyers might both provide legal advice and manage real estate and so on to get the pass-through deduction for the whole operation, trying to mix the businesses so that the IRS can't effectively distinguish.

  When it comes to the listed professionals, the IRS has more flexibility, which it should use to disallow such packing by them.[18] But, when it comes to others—the

[16] Thanks to Adam Looney for pointing out this strategy.
[17] Thanks to Steve Rosenthal for this insight on "packing" by the real estate mogul.
[18] Specifically, when it comes to the listed professionals, the IRS should avoid using the approach under IRC 448, which also restricts a similar list of professionals from certain tax benefits. Under that code section, the question is whether "substantially all" the activity come from those services. And so based on the Code and regulations there, packing clearly works. See IRC 448(d)(2) and 1.448-1T(e)(4). But, 199A (the pass-through deduction) reads differently than IRC 448, and the IRS thus should have authority to attack the "packing" strategy for listed profiessionals. Collapsing cross-referenced sections, the conference report provides that "[t]he term 'qualified trade or business' means any trade or business other than . . . any trade or business involving the performance of services

goops or reality TV stars of the world—it will be much more difficult for the IRS to attack such strategies..

- **Go in-house (or be an architect or engineer).** Another route for service partners is to simply work at a firm that is not in the business of providing the restricted services. They can go in-house (as a partner) at a partnership engaged in another line of business and get the full deduction. For example, a lawyer becomes a partner in a real estate firm. Or, if doing work at all related to construction/development, they may categorize themselves as "architecture" or "engineering" firms in order to avoid definitely being classified as a disfavored trade or business.[19]

- **Athlete's Brand, LLC—a game denied, or not?** Our prior report (and an earlier Washington Post article),[20] explained how highly paid services providers like doctors, lawyers and athletes might be able to access the business deduction by spinning off their "brand" into a separate firm. This new firm would not provide services but instead would manage the brand and therefore avoid the restrictions on professionals. (This may also be useful for, say, a reality TV star whose main source of income is royalties.)

  It is unclear whether or not the conference bill allows this game. The conference bill specifies that, if the principal asset of the firm is the "reputation" of the owner (and not just "employees" as in the prior version of the legislation), then this source of value also falls into the denied "service" category.

  This addition to the conference bill probably kicks out the law firm trying to spin off its reputation as a brand. However, if an athlete or someone in the performing arts (also listed) assigns the right to actively license his or her image and name to a pass-through, it would be the pass-through's intellectual property (the right to license the image), and not the reputation of the owner that would be its principal asset. So, this is yet another way that an athlete or entertainer could access the pass-through rate—in addition to the packing strategy discussed above. Argue that the source of value isn't reputation in the first place.

  Would this argument ultimately succeed? We don't know the answer, and will read future cases on these issues with interest. In at least some circumstances in the past, the IRS has

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in the fields of health, law, [etc.] . . . ." Cf. § 1202(e)(3)(A). Thus, a trade or business that involves both the performance of legal services *and* the management of real estate is, on a straightforward reading, still "a trade or business involving the performance of services in the field[] … of law." On this view, "packing" would be ineffective because any trade or business that involves a specified service and another enterprise still "involv[es]" the specified service.

[19] The degree to which architects and engineers get favorable treatment is unclear as a result of drafting problems in the conference bill. *See supra* note 8.

[20] See The Games They Will Play, *supra* note 1, at 11; Steven Pearlstein, The Bryce Harper Tax Relief Act, Washington Post Wonkblog (Dec. 1, 2017), https://www.washingtonpost.com/news/wonk/wp/2017/12/01/the-bryce-harper-tax-relief-act-of-2017/?utm_term=.7dafde70c44b.

not been particularly strict in its application of the rules defining when a firm's principal asset is the reputation or skill of its employees.[21]

To be sure, even if the spin-off game still works, that separate firm would need to pay sufficient W-2 wages (or own enough depreciable property)[22] to preserve eligibility, but this barrier could be overcome since managing these brands often involves services from others. Further, even if there aren't many employees, the firm could pay some W-2 wages to the original service providers (like the athlete) in order to get the deduction on the rest of the income running through the firm.

- **Property counting toward the pass-through deduction—game or a glitch or both?** In the new conference bill, pass-throughs can take the special 20% deduction now without paying any wages. They just need property. What kinds of property count? That's ambiguous. Apparently, for these purposes, property includes any kinds of tangible property that's in theory subject to depreciation. The initial cost of any such property gets counted for a minimum of ten years.

  First, this allowance generates several bad incentives and loopholes. Businesses are incentivized to own tangible property within the firm in order to take advantage of the pass-through deduction. Do not rent from others if the limitation on deductibility is having any bite. In fact, you could own very old property (like an old building) that has been depreciated over decades, but you count it as it were a brand new property, at its original cost. And, again, it is possible to do this and access the pass-through deduction even in the absence of any employees or W-2 wages paid.

  Basing eligibility for the pass-through deduction on depreciable property and wages can even incentivize businesses to engage in money-losing operations (making investments or paying employees) just to access the pass-through deduction.[23] This particular formula may even encourage businesses to replace employees with equipment in some cases.

  Second, the conference bill is ambiguous as to what property actually counts for these purposes—and taxpayers can play games here as well. Does computer paper count (so long as you keep the documents around the firm)? How about paper clips? They are both

[21] See Private Letter Ruling 201717010 (finding that a lab testing service qualified under section 1202 and neither provided a forbidden service nor had the skills or reputation of its employees as its primary asset).
[22] This is because even a "good" business with high income must meet the W-2 or asset basis test.
[23] Daniel Shaviro provides the following example: Assume a pass-through has no employees, and therefore no W-2 wages. The business buys a debt-financed asset for $100, with zero cash out of pocket. The asset earns a 6% rate of return, but the business pays 7% annual interest on the debt. Absent tax considerations, this would be a net money loser. Under the pass-through rules, however, the business can apply 2.5% of the cost of new asset ($2.50) towards the pass-through deduction, thereby reducing their taxable income by $3.50 per year (when added to the net $1 interest expense). At a 37% rate, this deduction will reduce the taxpayer's final tax liability by approximately $1.30, which is more than the economic loss from the money-losing investment. Shaviro describes some of these details in a recent blog post: http://danshaviro.blogspot.com/2017/12/under-new-tax-bill-lose-money-before.html.

forms of tangible property—in theory, subject to depreciation (if they weren't immediately expensed as business supplies). And, what about improvements to property? The provision says that you use "unadjusted basis" in this calculation allowing the deduction; improvements are an adjustment to basis. Do you get no credit for that? Should you buy improved property then rather than improve the property yourself in order to become eligible for the deduction? The questions go on, and the IRS has its work cut out for it.

In all of these cases, the fundamental problem is the lack of any underlying logic in deciding who benefits from the pass-through deductions, and who does not. Independent contractors and partners benefit, but not employees. Why? An owner of real estate through a REIT benefits, but not the doctor in the building. Why? An architect benefits in some ways that a lawyer does not. And so on. For each of these formalistic and seemingly arbitrary distinctions, there is a game to be played to fall within the favored category. The IRS should try to staunch the bleed in revenue—and action here is far better than nothing—but it will naturally be an uphill battle. The much better answer would be to simply eliminate the provision.

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

The conference bill caps the SALT deduction at $10,000, but permits a combination of taxes in order to reach that cap. For example, a taxpayer could deduct both property and income taxes up to this combined amount.

Some taxpayers will now find themselves at or below the cap and thus not directly affected by the partial repeal.[24] In many parts of the country, however, taxpayers pay state and local taxes well in excess of $10,000. This is why even a partial repeal of SALT remains such a significant revenue raiser.[25] For the same reason, affected states will still have ample incentive to respond creatively to the changes in federal tax law.

In our prior report, we described four possible responses by states and municipalities to restructure their revenue collections and preserve the SALT deduction. Three of these four strategies remain available to states under the conference bill. All involve transforming state taxes no longer deductible over the cap into economically equivalent payments to the government that remain deductible. Furthermore, although all of these strategies involve some

[24] These taxpayers, just like taxpayers who will no longer itemize at all because of the doubling of the standard deduction, might still be paying more under the conference bill. A lot depends in particular on how the taxpayer is impacted by the repeal of the personal exemption, increased child tax credit etc.

[25] Presumably the capping of the SALT deduction represents the lion's share of the $668 billion projected savings from the partial repeal of SALT, changing the mortgage interest deduction, eliminating non-casualty losses and miscellaneous expenses. For some analysis of the numbers of taxpayers who will be affected by partial SALT repeal, see https://itep.org/compromises-under-discussion-for-the-state-and-local-tax-deduction-do-not-fix-flawed-tax-bills/.

administrative complexity, they are all built on systems that are well understood and that are already in use in some states and localities.

- **Property taxes**. Both the House and Senate bills originally capped the SALT deduction at $10,000 and limited it to property taxes. One strategy was therefore to increase property tax liability while commensurately reducing state income tax liability. This strategy is no longer available under the conference bill, which allows deduction of both property and income taxes up to the combined $10,000 cap.

Nonetheless, the $10,000 cap remains, even if state and local jurisdictions have greater flexibility in the mix of taxes that can be deducted up to this amount. Collecting state and local revenues in excess of the cap, however, can still be accomplished through one of the remaining three strategies:

- **Employee payroll taxes.** The conference bill does not alter the analysis as to the potential shift to employee payroll taxes. Taxes imposed on a business are still deductible. Therefore states can shift from non-deductible over-the-cap state income taxes to still-deductible employer-side payroll taxes. It is important to repeat that that states already impose a payroll tax for unemployment insurance purposes, and many localities impose an additional payroll tax as well—and employers currently can claim a deduction for their portion of these taxes.

- **Charitable gifts**. The conference bill does not alter the analysis that the new law would permit the shift from use of non-deductible over-the-cap state income taxes to deductible charitable contributions to state and local governments. One point bears further emphasis: Many states already have laws in place granting state income tax credits for donations to certain funds, and the IRS has allowed taxpayers who take advantage of these credits to deduct their payments as charitable contributions rather than as state taxes.[26]

- **Business "franchise" taxes on pass-throughs**. State and local taxes, possibly including income taxes imposed on a business, remain deductible by pass-through businesses—so long as they are imposed on the entity itself rather than the individual.[27] As a result, state and local jurisdictions can impose a deductible tax on pass-throughs that approximates an individual income tax, while reducing individual income taxes that are no longer deductible.[28] Imposing such taxes might be appealing for reasons beyond the continued

[26] See Carl Davis, ITEP, Tax Bill Would Increase Abuse of Charitable Giving Deduction, with Private K-12 Schools as the Biggest Winners (Dec. 2017), https://itep.org/wp-content/uploads/vouchersheltersalt1217.pdf.
[27] See in particular footnote 170 of the conference report (page 79).
[28] As an administrative matter, this reduction would presumably be in the form of a credit against state personal income taxes for the entity-level tax. A 100% credit could arguably undermine the deductibility of the entity-level tax, but a similar argument did not prevail in the charitable contribution context. In any event, a state looking to these kinds of taxes to maintain deductibility *and* recapture some of the tax benefit that wealthy pass-through owners

deductibility of these taxes. The conference bill retains special low rates for many pass-through businesses; a state that imposes a new—or higher—tax on pass-throughs can capture some of this gain.[29]

- **A new one-time opportunity.** By design, many taxpayers will pay state and local taxes in 2018 that they would have been able to deduct in 2017. But tax year 2017 is not over. Perhaps then a winning strategy would be for individual taxpayers to pay some of their 2018 taxes in 2017 and deduct them before there is a cap. The conference bill anticipates this and attempts to prohibit it directly (more on this in a moment), but only as to income taxes. This suggests that prepayment of other taxes, and in particular property taxes,[30] may still be deductible in 2017.

  Also, as pointed out by Victor Thuronyi, the prohibition on accelerating income tax payments may not actually work as intended by Congress. Because of a possible drafting error in the conference bill, the prohibition appears to only apply to taxable years beginning with 2018. As a result, there might be no prohibition with respect to 2017, despite what they seem to have intended.[31]

D. International Games, Roadblocks, and Glitches[32]

The international tax provisions in the conference bill present numerous gaming opportunities, adverse consequences under international law, and undesirable incentives to locate investment and assets abroad. Nearly all of the issues we identified in the initial report are still present. One has been mitigated, but the statutory fix creates taxpayer unfriendly results.

For greater detail of these issues, see the discussion in our prior report at Part II.D. and the Appendix.

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will enjoy would not impose a simple 100% credit. A less than 100% credit that is greater for lower-income taxpayers is less likely to pose a problem for the entity-level tax.

[29] There are multiple other avenues available to states that are looking to recapture such gains or raise revenue for some other purpose—perhaps even for the purpose of making whole those taxpayers who lose on account of the partial repeal of SALT. State personal and corporate income taxes broadly conform to their federal counterparts, and thus states must decide whether or not to conform to the changes in federal law. These conformity choices can be made strategically. For instance, a state can choose to conform to the new provision limiting the deductibility of interest payments made by a business. Conforming in this instance can mean additional revenue for the state. Alternatively, or in addition, a state can choose to piggyback on the various new tax taxes created by this bill in the international arena.

[30] In California, for example, taxes are due in April and December. Many property owners have therefore received a property tax bill due in April 2018.

[31] See Victor Thuronyi, Whatever Source Derived, A Mistake in the Rule That Says You Can't Deduct State Income Tax Prepaid in 2017 (Dec. 17, 2017), https://medium.com/@vthuronyi/a-mistake-in-the-rule-that-says-you-cant-deduct-state-income-tax-prepaid-in-2017-ae6f55865e04.

[32] This section on international tax mainly reflects work by Rebecca Kysar, who has benefited greatly from discussions with multiple international tax experts over the last several weeks, in particular Reuven Avi-Yonah, Cliff Fleming, Mitchell Kane, Ed Kleinbard, Mike Schler, and Stephen Shay.

1. Problems with the minimum tax on global intangible low-taxed income ("GILTI")

- **The minimum tax formula induces companies to locate assets and investment offshore.** The conference bill imposes a minimum tax on global intangible income that is intended to stop U.S. corporations from shifting profits out of the United States. The base-shifting problem is exacerbated under the planned switch from a worldwide system (where the income of foreign subsidiaries earned abroad is merely deferred) to a territorial system (where it is exempted altogether).

  The minimum tax, as structured, is highly problematic. The conference bill exempts from the tax a deemed 10% return on tangible assets abroad, measured by tax basis. This rule encourages U.S. firms to locate tangible assets (and accompanying jobs) overseas.[33] There is no regulatory fix since this is a policy decision made in the bill.[34] The conference report suggests that certain non-economic transactions be disregarded in this context, however this language will not discourage firms from locating real assets offshore in order to reduce the minimum tax since such transactions will produce real economic consequences.[35]

  The deemed return on tangible assets is also set relatively high at 10% as compared to similar provisions in the code, which set returns a few percentage points above the risk-free return on Treasury yields. This allows a great deal of a company's return on investments in real assets abroad to be completely exempt from U.S. taxation.[36]

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[33] Perhaps the conferees thought that the location of tangible assets to avoid the minimum tax is a real response and therefore, since it has nontax consequences, is not abusive. The offshoring effect, however, is still present even if the activity has non-tax effects and indeed carries more severe consequences to the United States than if income is simply shifted in paper transactions. Additionally, a taxpayer may move tangible assets abroad, even if there is some diminution in pre-tax profits (that is, profits after foreign taxes but before U.S. taxes), in order to reduce U.S. tax liability by a greater amount than the loss of pre-tax profit. This analysis comes from discussion with Reuven Avi-Yonah and Dan Shaviro.

[34] The conference report also changes the rules governing where income is sourced when it comes from inventory that is partly produced in the United States and partly produced abroad. Current law allows taxpayers to effectively allocate half of the income to foreign sources by designating title to pass abroad. The new provision simply looks at location of production, which, like the minimum tax formula, may further incentivize firms to locate real production activities abroad. Thanks to Cliff Fleming for this point.

[35] The report goes further to state that "the conferees expect the Secretary to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under [the provision on one-time repatriation], but before the first taxable year for which [the GILTI provision] applies [2018], if such transactions are undertaken to increase [qualified business asset investment]." This language is aimed at transitional planning tactics like those identified by Stephen Shay rather than the asset shifting problem we identify. Stephen Shay, *Tax Reform—Process Failures, Loopholes, and Wealth Windfalls* (Nov. 21, 2017 draft), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3076151&download=yes.

[36] Consider a firm that invests $10 million in a plant abroad that will generate $1 million of income. It will get to exempt all of that income through the deemed 10% return, or $1 million, so that there is no U.S. tax. In contrast, a firm investing in a $10 million plant in the United States that will generate $1 million of income pays U.S tax of $210,000 (21% of $1 million). Note that the rate on the income from the U.S. plant would be lower if such income was export income, which is effectively taxed at a 13.125% rate in the conference bill. Where there happens to be

Furthermore, because the conference bill applies the minimum tax 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 trade-off then is tax at 21% for investment in the U.S. versus no marginal U.S. tax liability for an offshore investment. These incentives are fundamental to the structure of the legislation and cannot be cured by regulation.

- **The minimum tax can no longer be fully avoided through leveraging, but the statutory fix produces taxpayer unfriendly results.** As we mentioned in our prior report, under the Senate bill, a firm could borrow to buy tangible assets abroad, and the interest expense would shield intangible income from taxation. The tax benefits of this planning opportunity have been mitigated, but the statutory fix presents problems of its own.

  New rules in the conference bill limit arbitrage opportunities because they require that interest expense reduces the income that is exempt from the minimum tax regime rather than reducing the income subject to the minimum tax regime.[37] This mechanism effectively causes interest expense to reduce the 10% tax-free return on tangible assets.[38] However, the new rule may produce an anti-taxpayer result by stacking all interest expense first against the fixed tangible return rather than by using a pro rata allocation against tangible and intangible income. If a firm borrows to buy an intangible asset, the interest expense reduces the exempt return rather than nonexempt income.[39]

2. Problems with the reduced rate on export income (foreign-derived intangible income or FDII)

- **The reduced rate on export income can be gamed through resale transactions.** The conference bill effectively grants export income a favorable 13.125% rate. As we mentioned in our prior report, under one interpretation of the statute, taxpayers may be able to take advantage of this rate in "roundtripping" transactions, selling to independent

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non-exempt return to tangible assets (return in excess of 10%), this is taxed by the minimum tax regime but at a lower rate than the rate on domestic income. The minimum tax in this case might also be zero if the taxpayer pays enough overall foreign taxes.

[37] Specifically, the conference bill reduces the related foreign corporation's income from tangible assets by interest expense to the extent such expense exceeds the interest income properly allocable to that interest expense that is taken into account in determining the firm's share of the related foreign corporation's income.

[38] Under the Senate bill, if a firm borrowed $100 at 4% to buy an asset with no return, the firm could reduce the income subject to the minimum tax by $14 at a cost of $4. Under the conference bill's new rule, the firm can only reduce the income subject to the minimum tax by $6 (the $10 (10%) deemed return minus the $4 of interest expense). Thus, a firm can still reduce the income subject to the minimum tax by using leverage, but this is a function of the 10% deemed return, not the reduction of that baseline by the interest expense. In other words, taxpayers can still use borrowing to generate a tax benefit (the 10% tax-free deemed return), but the conference bill limits the arbitrage opportunities in creating deductible interest expense from borrowing that generates otherwise exempt income. This analysis comes from discussion with Mitchell Kane and Mike Schler.

[39] Thanks to Mike Schler for this point.

foreign distributors, perhaps with strings attached over advertising, marketing, and price, who then resell back into the United States. 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,[40] taxpayers will take the position that the intent of an initial sale to a foreign business is sufficient (like in a VAT regime). Treasury should address such transactions in regulations.[41]

- **The reduced rate on export income likely violates WTO obligations.** The greater the U.S. taxpayer's income from exports, the more of its income gets taxed at the 13.125% rate (as opposed to the 21% corporate rate). As we stated in our prior report, this regime is likely an illegal export subsidy in violation of WTO agreements.[42] This serious concern remains. Taxpayers should expect instability in this area, and the United States should prepare for WTO litigation. The most likely outcome is that the U.S. will abandon the export subsidy regime under threat of sanctions. Indeed, since our initial report, the foreign finance ministers of Britain, France, Germany, Italy, and Spain sent a letter to Treasury Secretary Mnuchin warning him of the possible violations in this regime.[43]

[40] Footnote 1522 of the conference report (page 497) states that "if property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing…outside the United States by such person, then the property is for a foreign use." This presumably allows for roundtripping so long as there is some degree of foreign processing since otherwise this rule would not be necessary. It is possible that, by negative implication, the conferees aimed to imply that a sale for reimportation would not be for foreign use in the absence of further foreign processing. Even if this interpretation of the negative implication is correct, there will be enormous pressure on the minimum amount of foreign processing necessary to qualify as foreign use, allowing reimportation into the United States. Regulations to address this point will be necessary, although it is questionable how effective they can be given the fact-intensive nature of the inquiry. Thanks to Mike Schler for discussion of this point.

[41] For instance, Treasury might use rules similar to those that determine destination under the base company rules to determine whether a sale is for foreign use. See Treas. Reg. 1.954-3(a)(3)(ii). Problems with these rules, however, illustrate the difficulties in addressing the roundtripping issue. For one, the base company regulations mandate that corporations determine the country of ultimate use "if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination." This leaves substantial wriggle room for there to be no duty for U.S. firms to determine which property will be resold into the United States when they sell property to an independent foreign party for resale. In light of the statutory requirement that taxpayers show to the satisfaction of the Treasury that the property is exported for foreign use, Treasury should use its regulatory authority to impose an interpretation of the statute that requires U.S. manufacturers to do a real investigation of how much the foreign party will sell back into the United States, although given the fact-intensive nature of the inquiry it is unclear how effective any such regulations will be.

[42] For further discussion, see Rebecca Kysar, *The Senate Tax Plan Has a WTO Problem*, Medium (Nov. 12, 2017), https://medium.com/whatever-source-derived/the-senate-tax-plan-has-a-wto-problem-guest-post-by-rebecca-kysar-31deee86eb99.

[43] *EU Finance Ministers Warn Against Proposed U.S. Tax Measures*, Tax Analysts Worldwide Tax Daily (Dec. 11, 2017). The finance ministers note that the export regime is different from accepted patent box regimes in that it applies to intangible assets other than patents and copyright software, such as branding and other market-based intangibles.

Another possible outcome—the tax measures pursued in this bill may destabilize the free trade order, and there is already indication that this is occurring.[44]

- **The reduced rate on foreign derived intangible induces firms to sell to foreign (and not domestic) manufacturers and does not alleviate the offshoring problem with respect to IP.** The export subsidy rate incentivizes firms to sell unfinished products to foreign manufacturers since these sales qualify for the lower rate whereas sales to domestic manufacturers do not. In our initial report we also recommended equalizing the minimum tax rate on GILTI (now taxed at 10.5% under the conference bill) and the reduced rate on exports (now taxed at 13.125%) since the rate differential punishes the activity we want to encourage (exports) and encourages the activity we want to punish (GILTI) where there are little or no foreign taxes paid. This issue is still a problem in the conference bill. [45]

3. Problems with the Inbound Provisions (BEAT)

- **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 conference bill imposes additional tax liability on deductible payments between a U.S. subsidiary and a related foreign entity. It does this by adding back certain related party payments and imposing additional tax liability on this expanded base, effectively ensuring that at least a 10.5% tax is imposed on such income. As we discussed in our initial report, this presents WTO problems and may be viewed as a forbidden tariff or discriminatory. Under the letter from the European finance ministers to Secretary Mnuchin, mentioned above, however, WTO concerns were not mentioned explicitly in connection to BEAT (although the letter did mention "unfair trade practice"). This omission may be because the level of WTO-covered import activity subject to increased taxation is not sufficient to raise the ire of our trading partners.[46]

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[44] *World Trade Order in a Wobble as Washington Snubs WTO Status Quo*, Reuters (Dec. 15, 2017), https://www.reuters.com/article/us-global-economy-outlook/world-trade-order-in-a-wobble-as-washington-snubs-wto-status-quo-idUSKBN1E91GY.

[45] The conference report states the lower minimum tax rate under GILTI is justified because only 80% of the foreign tax credits are allowed to offset minimum tax rate. (13.125% equals the effective GILTI rate of 10.5% divided by 80%.) As we stated in our initial report, however, this justification does not hold if no or low foreign taxes are paid (for example, in tax havens), which are precisely the circumstances at which the GILTI regime is aimed. In such cases, firms will pay a 10.5% rate in the U.S. (or close to it). Given the goal of using the export rate to encourage firms to bring intellectual property back home, this policy choice is questionable. At minimum, a rate somewhere in between 10.5% and 13.125% could have been chosen to account for the tax haven problem. This is a policy problem in the bill, and there is no regulatory fix for it.

[46] Interest and royalties do not create a WTO issue, so only imports of depreciable property from related parties and imports from certain inverted corporations will implicate the agreements. Reuven Avi-Yonah, *Tit for Tax: How Will Other Countries React to the Tax Cuts and Jobs Act?* (draft Dec. 17, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089052.

As discussed in our initial report, the Senate's inbound rules were less problematic than the House's with respect to our obligations under the double tax treaty regime. The conference bill largely adopts the Senate's approach. That being said, we noted that our treaty partners will likely still argue that the regime violates the nondiscrimination requirement in the treaties. That is still the case under the conference bill. Indeed, in the letter from the European finance ministers to Secretary Mnuchin mentioned above, the foreign ministers argue that the regime results in double taxation by taxing foreign payments in the recipient jurisdiction without allowing for full deductions in the United States.[47] The United States shall anticipate the erection of similar regimes by our trading partners applicable to U.S. multinationals[48] and also subsequent pressure from our treaty partners to scale back the inbound regime on a bilateral basis.

- **Additional planning opportunities and unintended consequences.** Since issuing our initial report, we have had the chance to analyze further planning opportunities and problems with the House, Senate, and final conference bills:

  Royalty payments from a U.S. firm to its foreign affiliate, which holds intellectual property, would be included in the expanded base. If a foreign affiliate incorporates the foreign-held intellectual property into a product and then sells the product back to a U.S. affiliate, this could be considered cost of goods sold that is not captured by the inbound regime.[49]

  Note also that the conferees did not respond to legitimate concerns that BEAT captures non-abusive commercial transactions, such as repos and securities lending, while excluding derivatives.[50] BEAT also captures routine transactions such as a foreign finance affiliate borrowing for the group and on-lending at cost around the group. As a result, taxpayers may be penalized under BEAT for non-abusive transactions.[51]

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[47] *Id.*

[48] Many countries, however, may be limited in their ability to retaliate because, unlike in the United States, their constitutions prevent treaty overrides by domestic statute.

[49] Thanks to Ed Kleinbard for this point. *See also* David L. Koontz & Jeffrey M. Kadet, *Internet Platform Companies and Base Erosion—Issue and Solution*, Tax Notes (Dec. 4, 2017) (discussing how the inbound regime misses a lot of profit-shifting).
Also note that there are incentives for firms to expatriate given that they can avoid the minimum tax regime post-expatriation and can avoid BEAT by structuring transactions with unrelated parties even if the expatriated firm is a "surrogate foreign corporation" under 26 U.S.C. § 7874 (or by using the cost of goods sold with related parties tactic if not). Thanks to Reuven Avi-Yonah for this point.

[50] Telis Demos, Wall Street Journal, *In Tax Plan's Fine Print, Banks Find a Problem* (Dec. 13, 2017).

[51] The conference bill also contains taxpayer-unfavorable glitches. A firm may not pay the minimum tax on GILTI because they have paid foreign tax. In measuring BEAT, however, the firm has to include GILTI because foreign tax credits are not allowed in the calculation. Thanks to Ed Kleinbard for this point.

4. International Tax Competition

Supporters of the conference bill sometimes assume that lowering the statutory rate to below the OECD average of 25% will result in considerable investment into the United States, but other countries will likely respond to the changes enacted by the conference bill by engaging in tax competition.[52] For instance, other countries may cut their foreign tax rates further below the new U.S. rate of 21%.[53] They may also adopt patent boxes in response to the lower rate on exported intangibles or may impose greater taxation on U.S. subsidiaries of their own multinationals through rules similar to our controlled foreign corporation rules.[54] All of these realistic responses might reduce the dynamic growth effects of the conference bill and interfere with the intended aims of the new regime.

E. Other Games

There are many other games to be played under this legislation, undermining revenue collection and the integrity of the tax code—and leading to inefficient behavior. Here are several additional opportunities:

1. Arbitrage money machines.

The tax bill creates opportunities to use rate differentials and ill-considered transitions to engage in transactions that serve to basically pump money out of the Treasury and into the pockets of well-advised taxpayers. Some of these can be done by just the taxpayer; others involve finding a counterparty with a different set of characteristics. For instance:

- **Sell that old equipment: Get a windfall![55]** The conference report adopts the House's more generous expensing provision, which allows an immediate write-off for the cost of certain investments. Specifically, the provision applies not just to purchases of new property but also to old property. The key problem is that this includes old property already purchased *before* expensing took effect. So, what does that mean? It means that old property can still get the benefit of expensing, but only if it is sold to another party. If the original owner holds it, they have to depreciate according to the old rules; if they sell

[52] A classic example of tax competition is the 1984 U.S. abolishment of a withholding tax on foreign residents who earned portfolio interest. This sparked a "race to the bottom" among governments across the globe, leading to the current state of affairs whereby most countries do not tax interest on debt held by foreign persons.

[53] This point comes from discussion with Dan Shaviro. Note that predictions of an uptick in inbound investment are in tension with fact that we continue to exist in a low interest rate environment in which corporate CEOs report that capital access presents no constraints on undertaking projects at the margin. However, even if there are no capital allocation effects, the *perception* by other countries will be that the US has made a strong tax competitive move here. The rates in other counties may well come down in response. This will aggravate the new incentive we have created to move tangible assets out of the United States, as discussed under the GILTI regime. This point comes from Mitchell Kane.

[54] For further discussion, Reuven Avi-Yonah, *Tit for Tax: How Will Other Countries React to the Tax Cuts and Jobs Act?* (Dec. 17, 2017 draft), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089052.

[55] For further discussion of possible games with expensing, see Schler, *supra* note 6, at 1734.

it to another party, then suddenly the full cost is eligible for expensing, and the net effect is an immediate deduction of the existing tax basis of the asset. The parties can split the resulting surplus.[56] It appears that the buyer of the asset could even lease it back to the existing owner, so that the property doesn't even have to go anywhere.[57] It's a further generous, and unjustified, hand out to existing investment.

- **The pass-through loss game.** As in the previous Senate and House bills, the conference bill continues to allow pass-through losses to be deductible against ordinary income taxed at higher rates—even as income generated by the pass-through would get the lower rate. This then reduces the future ability to take the pass-through deduction, but, since they don't strictly basket the losses with the income of the same character, it creates a possible arbitrage across the rates, especially if transactions are arranged to generate income upfront with losses after.

2. Avoiding the Interest Limitation with a Pass-Through

Following the House and Senate bills, the conference bill caps business interest expense deductions at 30% of an adjusted measure of profits. The cap excludes interest earned by the business, which may be fully offset by interest paid. This interest limitation is considered a necessary rule to prevent a business from deriving a double benefit from the purchase and expensing of debt-financed property.[58]

However, for pass-throughs, there is a way out of the limitation, as Daniel Hemel has described.[59] Specifically, transform the payment from an interest payment into something very similar that is considered to be a payment on an equity interest in the partnership. A corporation could try the same maneuver directly, but will not find any tax benefit since dividends are not deductible to the corporation. The same is not true for profit shares paid out of partnership, which will now be taxed preferentially relative to debt financing. They are essentially deductible to the partnership, and only taxed once at the individual level. Not only that—but investors who hold preferred equity-like interests in these partnerships potentially would be eligible for the new 20% deduction. So, the basic game for a partnership is to pay out preferred returns on equity instead of interest. As it turns out, corporations can get access to the same arrangement, but by stacking entities as described below.

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[56] If the purchaser is a flow-through, the purchase may also allow its owners to qualify for the flow-through deduction under the new rule that allows the deduction up to 2.5% of the acquisition cost of tangible depreciable property.

[57] Of course the arrangement would have to be structured as a true lease for tax purposes. For a discussion of this additional planning opportunity, see Schler, supra note 6, at 1734.

[58] For more detail on the benefit of expensing debt-financed property, see Chris Sanchirico, Expensing and Interest in the GOP Blueprint: Good Idea? Bad Idea?, 155 Tax Notes 339 (April 17, 2017).

[59] See Daniel Hemel, How to Skirt the Cap on Interest Deductions in the GOP Tax Plan . . . and to Make Some Money While You're at It, Whatever Source Derived (Dec. 13, 2017), https://medium.com/whatever-source-derived/how-to-skirt-the-cap-on-interest-deductions-in-the-gop-tax-plan-bca62fc58a4f. These strategies were suggested to the author by a lawyer specializing in structured financial transactions.

The IRS may try to attack this by recharacterizing partnership preferred equity as debt under section 707(d), which applies to guaranteed payments by a partnership. However, section 707(d) applies only for the purposes of specific sections and subsections of the Code, and does not apply to the cap on interest deductions under the proposed section 163(j).

3. Games with Stacked Entities (the Up-C Structure)

Another set of games involve stacking a corporation on top of a pass-through to generate better tax results (sometimes called the Up-C structure)—and especially to bypass some of the restrictions that would most affect corporations alone, like the limitations on deductibility of interest and executive compensation. The Up-C structure—which provides a workaround—involves a public C-corporation being a partner in a partnership that owns all of the assets of the business.

This structure could allow taxpayers to avoid key provisions in the conference bill through the following games:

- **Allowing corporations to avoid the interest limitation.** Just like a partnership, the Up-C could finance itself with what is essentially fully deductible interest, as Hemel also describes.[60] Specifically, the partnership would issue the preferred equity and bank the full deduction at the partnership level. Thus, the corporation itself never borrows; it's the partnership doing the quasi-debt financing (via preferred equity), and getting the full deduction as a result. (And, again, if the corporation tried to do this directly, it wouldn't save taxes since dividends aren't deductible to it.)

  In theory, Treasury and the IRS could use their broad power under section 385(a) of the Code to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness." However, those section 385 powers would seem not to apply in cases when the subsidiary partnership of the corporation (rather than the corporation itself) issues debt-like preferred equity.

- **Allowing corporations to avoid the deduction limitation on executive compensation.**[61] The Conference bill amends section 162(m) to further limit public (and certain private) companies' ability to deduct certain salaries in excess of $1 million, and limits businesses' ability to deduct interest expense. Again, the Up-C can avoid a deduction limitation. Make the executives partners in the partnership and not necessarily employees of the corporation. The executive could receive their compensation in the

[60] See id.
[61] For more on this, see David Miller, "Tax Planning Under the Tax Cut and Jobs Act: Flow Throughs Are the Answer to Everything" (December 13, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3070662.

form of allocations of income via the partnership. This would not be salary or wages, and thereby would avoid the section 162(m) limitations, and would additionally provide the executive with the pass-through rate.

F. Other Glitches

Our prior report described glitches in both the House and Senate bills that would unduly penalize taxpayers, such as the reintroduction of the Corporate AMT in the Senate bill and the rules for capital contributions to corporations in the House bill.

The conference bill eliminated both of these glitches, but other potential problems remain. Some of these could inadvertently raise revenue, while others could be costly. Here are a few:

- **Paying taxes on legal settlements that go to the lawyers, not to the victim.** The conference bill entirely eliminates "miscellaneous itemized deductions." As Gregg Polsky points out, these deductions are already restricted under current law, but, in some cases, can still provide important—and appropriate—write offs. For instance, contingency fees for lawyers in legal settlements in cases involving such issues as defamation, intentional infliction of emotional damage, and punitive damages are now only deductible as miscellaneous itemized deductions. With that eliminated, there would be no deduction—and a victim would be taxed on income that she doesn't actually have (even as the lawyer is also taxed on the contingency fee being paid). For a 1/3 contingency fee, the result would be a 70% after-tax reduction in the recovery (since for $100 of recovery, the tax would be $37 and $33 would go to the lawyer.)[62]

- **Heads you lose; tails you lose.** The Conference bill adds a new section 451(b) that provides that, for an accrual method taxpayer, the "all events test" is met with respect to an item of gross income when the item is taken into revenue on the taxpayer's 10-K or audited financials. Let's assume that the taxpayer is a mutual fund that reports its income on a mark-to-market basis for GAAP purposes. Half of the mutual fund's securities go up by $10 and half go down by $10. The all events test is deemed met for the half that went up, but not the half that went down. The all events test is the trigger for tax liability. Therefore, the unhappy mutual fund has taxable "phantom" income for the half that went up, but no economic income (because the other half went down), and no cash (because none were sold). This is not what the drafters meant (and they tried once to fix it), but the words say what they say.

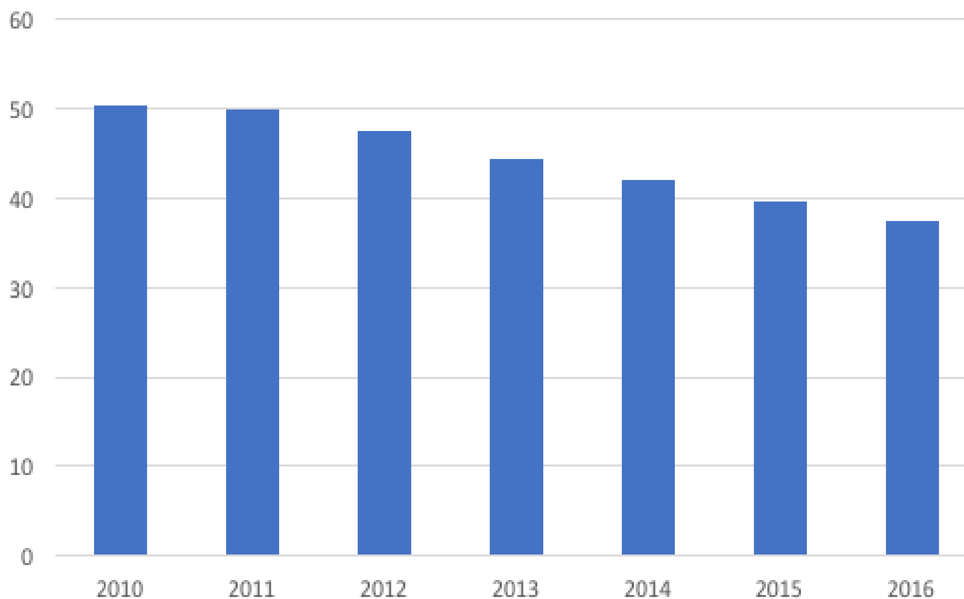
We expect that, with more time and analysis, many more such problems will be identified.

[62] Thanks to Gregg Polsky for this insight, sent to us by e-mail.

III. What Comes Next?

We are deeply concerned by the challenges ahead for the tax system and its admnistration over next several years. Treasury and the IRS are being handed a herculean task of immediately implementing a large number of complex and ambiguous provisions in just a few short weeks. Moreover, the new pass-through deduction will likely result in a massive restructuring of employment and service arrangements across many industries.

The immediate priority is for the IRS and Treasury to be granted substantial latitude to issue preliminary guidance, in order to reduce uncertainty and to warn of games that will not be allowed—to be followed with new rulemaking. Especially since Trump's appointed Assistant Secretary for Tax Policy is now serving as Acting IRS Commissioner as well, these actions will depend on the Trump administration not avoiding rulemaking as they have in many other areas.



We expect 2018 to be something of a "wild west" for well-advised taxpayers and their advisors, who will rush to create "facts on the ground" that would hinder IRS efforts to reverse some of the gaming—making swift action from Treasury and the IRS all the more important.

A second priority is to give the IRS the resources it needs to issue such rules and to enforce them. The IRS is unfortunately well behind what it should be. Since 2010, IRS funding fell 18% in real terms. The number of IRS employees in enforcement has fallen by over one-quarter, and the Trump Administrations FY18 budget proposed yet another reduction. This trend will take

time to reverse, but it will be all the more important to do so with this new bill in place. Put simply, with so many new games to play, large amounts of revenue could depend on the IRS's capabilities in shutting them down.

Finally, there should be an agenda to fundamentally overhaul—and, in many cases reverse—the changes that would be made by this new law. As we said at the start, the haphazard lines and the ways in which this legislation differentiates between winners and losers for no discernable policy reason ultimately undermines the basic integrity of the income tax. Unfortunately, there is only so much that the IRS can do to protect the tax system; much of the damage will need to be corrected through future legislation.

Appendix: Summary of Key Provisions in the Conference Bill

The conference bill roughly follows the provisions in the Senate bill[, while incorporating some features from the House bill. In particular, the conference bill would make the following changes to the tax law that are relevant to the analysis in this report (this summary is simplified for the purposes of the discussion):

- **Taxation of individual ordinary income.** Individuals will be taxed on their ordinary income (such as wages) at a top statutory rate of 37% through the year 2025, which is a reduction of 2.6% from the current top rate of 39.6%. The 3.8% tax on net investment income is preserved, as well as additional payroll and Medicare taxes, resulting in a top possible marginal rate of 40.8%.

- **Taxation of C-corporations.** All C-corporations are taxed at a flat 21% rate beginning in 2018, including "personal service corporations" which are taxed differently under current law.

  The "dividends received deduction" for dividends from an unaffiliated domestic corporation is reduced from 70% to 50%. As a result, such dividends will be taxed to the payee corporation at a 10.5% rate.[63]

- **Taxation of pass-through income.** A taxpayer may deduct 20% of "qualified business income" earned through a partnership, S-corporation or sole proprietorship. A taxpayer's qualified business income does not include amounts paid by an S-corporation or a partnership that are characterized as compensation.

  Qualified business income is capped at 50% of the wages paid by the business to its employees. Capital intensive businesses without significant wage income (such as real estate and automated manufacturing) can instead apply a cap that is the sum of 25% of wages paid plus 2.5% of the cost of certain qualified business property.

  Certain activities are excluded from the category of qualified businesses, including may professions such as law, financial services, and athletics. Taxpayers below a threshold amount ($315,000 of taxable income for a joint return) are not subject to the wage cap nor the exclusion of certain activities.

- **Deduction for state and local taxes.** All individual taxpayers have a choice whether to itemize their deductions or take the standard deduction. The conference bill doubles the standard deduction and so reduces the number of itemizers. The suspension of the Pease limitation on itemized deductions, however, could increase their value for higher-income taxpayers.

[63] 50% of the 21% corporate tax rate.

State and local taxes (SALT) for individuals can still be itemized and deducted, but only up to $10,000. The $10,000 cap can be reached through a combination of property and income taxes (or sales taxes instead of income taxes).

- **International Tax.** The basic structure of the international reform has four key elements:
    - Exemption of foreign income of U.S. corporations from taxation in the United States (a territorial system)
    - Backstopping the new territorial system with a 10% "minimum tax" on foreign-source intangible income (the "global intangible low-taxed income" or GILTI regime)
    - A special low rate on export income in the United States (the foreign-derived intangible income or "FDII" regime); and
    - Targeting profit-stripping by foreign firms operating in the United States (the "base erosion and anti-abuse tax" or BEAT regime).