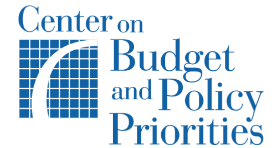
2017 Tax Law Invites Rampant Tax Sheltering and Gaming



The 2017 tax law not only ignores the need for more revenue and is heavily tilted in favor of wealthy people and corporations, but also suffers from a third fundamental flaw: its design invites rampant tax sheltering and gaming.[1]

True tax reform simplifies the tax code and narrows the gaps between how different types of income are taxed. The 2017 tax law does the opposite, adding complexity to the tax code and introducing new, arbitrary distinctions between different kinds of income, thereby creating new gaming opportunities. In particular, its new deduction for "pass-through" income and deep cut in the corporate tax rate risk making the 37 percent top individual tax rate merely theoretical for some very wealthy people. The law also confers enormous tax benefits on some industries but not others, makes it easier for wealthy households to shelter their assets and thereby accumulate multi-million-dollar fortunes, and favors business production and investment overseas rather than at home.

Widespread abuse of the bill's loopholes and preferences could cause it to lose even more revenue — and increase inequality even more — than current projections indicate. Moreover, Congress has depleted the enforcement division of the IRS, cutting its workforce by more than a quarter since 2010, and provided no additional funding for enforcement following enactment of the law.[2]

2017 Tax Law Is Opposite of True Tax Reform

Well-designed tax reform eliminates loopholes and reduces opportunities for gaming the tax system so that individuals and businesses with the same income are treated as similarly as possible. This brings several benefits:

- It increases the degree to which individuals and businesses base their decisions on economics instead of taxes. This is good for the economy: it encourages resources such as capital and labor to flow to where they are most productive instead of where the tax breaks and gaming opportunities are most plentiful.
- Closing loopholes and eliminating opportunities for gaming raises revenue and may also reduce inequality, since wealthy individuals and corporations are best equipped to exploit these weaknesses in the tax code.
- It reduces the amount of economic resources that are diverted to developing sophisticated tax avoidance schemes that provide little overall economic benefit, allowing those resources to go to more productive uses.

The 2017 tax law moves in the opposite direction. It creates new loopholes that will result in similar economic activities being taxed, often arbitrarily, at different rates. Hence, it "has turned us into a nation of tax shelter hunters," as the Tax Policy Center's Howard Gleckman has observed, as various parts of the law have "set off a frenzy of loop-hole seeking."

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[1] For further information, see Chuck Marr, Brendan Duke, and Chye-Ching Huang, "New Tax Law Is Fundamentally Flawed and Will Require Basic Restructuring," Center on Budget and Policy Priorities, updated August 14, 2018, https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring.

[2] Emily Horton, "2018 Funding Bill Falls Short for the IRS," Center on Budget and Policy Priorities, March 23, 2018, https://www.cbpp.org/blog/2018-funding-bill-falls-short-for-the-irs.

Changes Risk Undermining Integrity of Tax Code

Provisions of the 2017 tax law that create new gaming opportunities include the following:

- **Deduction for "pass-through" income invites abuse.** The law introduces a 20 percent deduction for "pass-through" income, or income from businesses such as partnerships, S corporations, and sole proprietorships that business owners claim on their individual tax returns. This provision never enjoyed a solid policy rationale: although proponents argued that it was necessary to maintain "parity" between the taxation of corporate and pass-through business income, pass-throughs already enjoyed a tax advantage over regular corporations (known in the tax code as C corporations). While pass-through income faces only one layer of taxation — at the individual level — C corporation income faces two levels of tax: one when the firm pays the corporate income tax, and another when shareholders pay individual income tax on their dividends or capital gains. Because of the new deduction, many high-income individuals may now be able to secure very large tax savings by converting their wage and salary income into pass-through income.

  The law includes a series of complex "guardrails" aimed at limiting the scope of the provision and preventing gaming, but these measures are unlikely to be effective. They consist of a series of questions for taxpayers to determine whether particular income qualifies for the pass-through deduction, with each question drawing a line between qualification and disqualification for the deduction. (Among other things, the law draws lines between compensation and profits, between different types of services, and between real estate investment trusts and other assets.) This will entice many taxpayers, aided by their accountants or lawyers, to try to place themselves on the tax-saving side of each line. Such tax avoidance activities produce no gain for the economy and lose revenue for the Treasury.

- **Deep cut in corporate rate risks encouraging tax sheltering.** The law creates a powerful incentive for wealthy Americans to shelter large amounts of income in corporations by slashing the corporate rate to 21 percent, far below the top individual tax rate of 40.8 percent (the new 37 percent top individual income tax rate plus the 3.8 percent Medicare payroll or net investment income tax rate). This will entice wealthy people to shield their labor or interest income from the top individual rate by setting up a corporation and reclassifying their income as corporate profits in order to pay the lower corporate rate. They also can defer the second level of tax on their corporate income by electing not to receive dividends immediately or by delaying selling shares and realizing a capital gain.

  The law also encourages income sheltering by retaining the "stepped-up basis" loophole, which allows the heirs of an estate not to pay any taxes on any appreciation of an asset that occurred during the previous owner's lifetime. The combination of the new low corporate rate and this retained tax loophole risks opening a gaping tax sheltering opportunity for wealthy people, with no gain for the economy.

  For example, an investor with a multi-million-dollar bond portfolio now has an incentive to place it in a corporation and pay roughly half the tax rate on the interest income it produces than she'd pay if that income faced the individual tax rates. She might eventually have to pay taxes on the dividends or capital gains on the wealth that has accrued in the corporation, but she could defer that second layer of tax for decades and even avoid it altogether by passing the corporation housing her bond portfolio on to her heirs and relying on the stepped-up basis loophole to wipe out her tax liability.

- **New international tax regime encourages offshoring and profit shifting.** The 2017 tax law also moves U.S. international tax rules toward a "territorial" system that largely exempts multinationals' foreign profits from U.S. tax and thereby encourages them to shift profits and operations overseas. The drafters of the law put in place a minimum tax to limit this incentive, but it is flawed and could in fact add to incentives to shift both paper profits and real investments and operations overseas since multinationals owe less minimum tax when they invest more abroad. This threatens to reduce investment in the United States and could wind up reducing U.S. workers' wages.

Updated October 25, 2018