MEMORANDUM

To:	Democratic Tax LAs
From:	Democratic SFC staff
Date:	December 8, 2016
Re:	Problems with the Brady Blueprint

Ways and Means Republicans released a Blueprint for tax reform, called "A Better Way," on June 24, 2016. As you discuss the proposal with your Member and take meetings, we wanted to share some recurring issues that have surfaced as we have analyzed the proposal. Because the House Blueprint is so brief, the issues list that follows is by necessity tentative and incomplete. Several of these issues require deeper examination than can be summarized here, and we will share more analysis as things progress. In the meantime, we are available to answer any questions you might have and provide additional memos and briefings in the future.

Key takeaways:

(1) The House Blueprint is highly regressive and fiscally irresponsible.

(2) The House Blueprint expands many tax breaks for the wealthy and cuts back many deductions and credits that are important to the poor and middle class.

(3) The key feature on the business side of the plan—a destination-based cash flow corporate income tax with "border adjustments"—is confusing, untested, leads to bizarre results, and is possibly illegal under WTO rules.

Overview of the Blueprint

The Blueprint makes significant changes to the individual side of the tax code, reducing rates and eliminating many popular deductions and credits. It implements a new and untested business tax system that in some ways resembles a consumption tax. Changes on both the individual and business sides would drastically reduce federal tax revenue. The most notable features include:

Individual

- Individual rate: consolidates seven brackets into just three: 12%, 25%, 33%.
- Combines the standard deduction (including the additional deduction for the blind and elderly) and the personal exemption into a larger standard deduction that benefits some filers (childless adults) and hurts others (middle class households with children)
- Repeals individual Alternative Minimum Tax (AMT).
- Reduces taxes on capital income (50% exclusion on capital gains, dividends, and interest); repeals 3.8% tax on net investment income ("NII").
- Repeals all taxes associated with the Affordable Care Act.
- Eliminates most individual tax preferences, except
    - EITC, Child Tax Credits (but requires SSNs to claim refundable portion),
    - Higher Education Tax Credits (but consolidates)
    - Exclusion of employer-paid health insurance, health savings accounts, flexible spending accounts
    - Home mortgage interest deduction, charitable deduction
    - Retirement savings incentives
- Repeals estate and gift taxes

Business

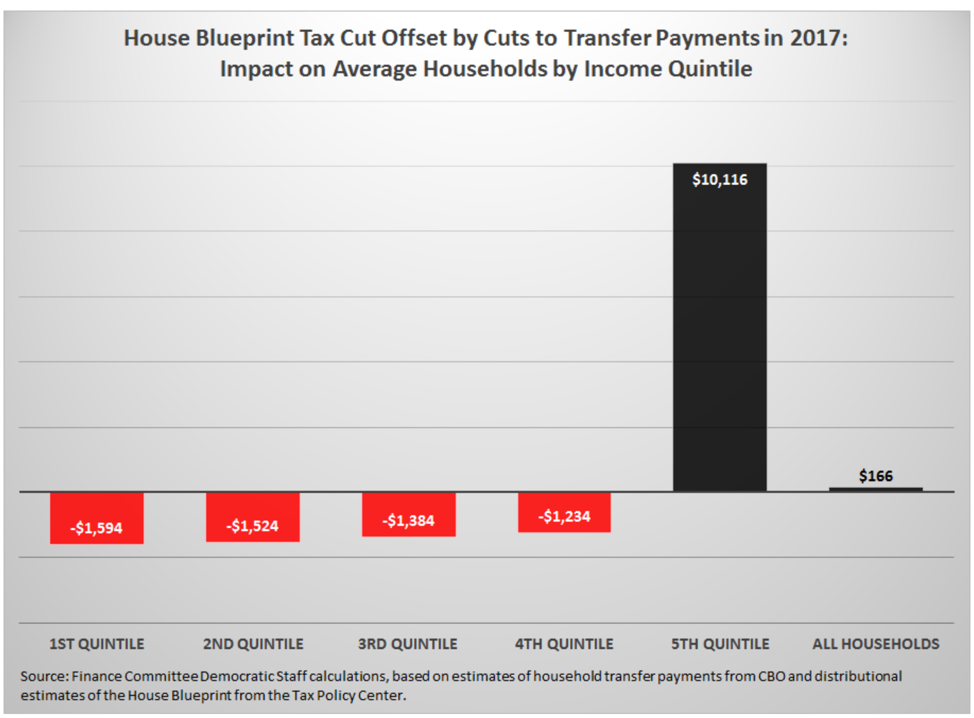
- Reduces tax rate on passthroughs to maximum of 25%.
- Reduces tax rate on C Corporations to 20%, repeals corporate AMT.
- Immediate expensing of all depreciable property (including real property).
- Limits interest deduction to net interest; net interest expense carried forward indefinitely.
- Preserves R&D credit.
- Changes business tax base to US-only sales ("destination-based" system).
- Taxes old accumulated foreign-source earnings at 8.75% (cash or cash equivalents) or 3.5% (if already reinvested offshore).
- Implements "border adjustments" by excluding exports from the tax base and denying US companies a deduction for imported goods or services.

Key Problems: Individual Side

1. The Blueprint is unfair to the poor and middle class.

The House Blueprint is extremely regressive. While all income quintiles would see a reduction in taxes, about three-quarters of the tax cuts benefit the top 1 percent of all taxpayers. Also, eliminating the dependent exemption as part of expanding the standard deduction increases the tax bill on middle class taxpayers with children, according to TPC estimates. The reduction in top marginal rates from 43.4 to 33 percent benefits high income professionals, while the reduction in capital gains taxes from 23.8 to 16.5 percent benefits mainly investors and top fund managers. The tax rate on carried interest would also drop from 23.8 to 16.5 percent.

Regressivity would be exacerbated if Republicans intend to (eventually) offset the cost of the Blueprint through cuts to transfer payments. Finance staff estimates based on households transfer payment data from CBO and distributional estimates of the Blueprint from the Tax Policy Center, that, for 2017, households in the top quintile receive all of the net gains, at the expense of the bottom four quintiles.



2. The Blueprint is fiscally irresponsible and would explode the federal deficit.

The House Blueprint reflects a belief that tax cuts pay for themselves (or, perhaps, that deficits don't matter). The Tax Policy Center estimates that the Blueprint would reduce federal tax revenues by at least $3 trillion on a static basis and at least $2.5 trillion after accounting for the macroeconomic effects of growth (dynamic scoring). Strategies for dealing with the deficit problem might include:

1) The Republicans could try to reduce the cost of the overall package by enacting more aggressive loophole closers, as Republican Dave Camp did in his proposed tax reform bill in 2014.

2) The Republicans could downplay the JCT score and instead focus on estimates by the Congressional Budget Office or even outside groups like the Tax Foundation, who might assume, unrealistically, that the tax cuts would magically create 4 percent GDP growth. The lower JCT estimate, however, would remain binding for budget reconciliation purposes, leading to an end result that if the Blueprint were pushed through the budget reconciliation process, the legislation would have to sunset in whole or in part before the close of the budget window.[1]

3) The Republicans could enact spending cuts to offset the decline in federal tax revenues. Because the decline in federal tax revenues is so large, this would probably require a massive cut to federal entitlement programs like Medicare and Medicaid.

The most likely result is some combination of all three approaches.

3. The Blueprint selectively targets certain important deductions.

The Blueprint does not represent a balanced approach to tax reform. Instead, it eliminates certain tax breaks deemed politically vulnerable, such as the federal deduction for state and local taxes and the municipal bond interest deduction (which helps cities borrow at a lower interest rate). Meanwhile, it preserves other tax breaks, such as the home

[1] The Byrd Rule prohibits any title in a reconciliation bill from increasing the budget deficit in any "out-year" outside the budget window.

mortgage interest deduction and charitable deduction. The Blueprint, in other words, does not take a purist's approach to tax reform.

4. The Blueprint unfairly lowers taxes on capital gains.

The Blueprint provides a 50% exclusion for capital income (capital gains, dividend income, and interest income), effectively lowering the top rate on capital gains by one-third, from 23.8% to 16.5%. The top 0.1% realize about half of all capital gains. There is no empirical evidence that, in this range of rates, a capital gains cut meaningfully increases investments incentives or savings/consumption margin. Rather, its primary effect is inframarginal—rewarding rich people for investments they would have made (or already have made) anyway.

5. The Blueprint expands the carried interest loophole.

Instead of closing the carried interest loophole, the Blueprint is silent on the issue. In effect, then, it lowers the tax rate on carried interest and other forms of disguised labor income from 23.8% to 16.5%. (This would violate a Trump campaign pledge to eliminate the loophole.)

6. The Blueprint repeals the estate tax.

The estate tax plays two critical roles in our tax system. First, the estate tax can help mitigate high-end inequality and prevent dynastic wealth. Second, it acts as a backstop to the income tax. Under current law, heirs receive a "step up in basis at death," meaning that any unrealized gains on inherited property escape the income tax forever. For very large estates, however, the estate tax gives the government a second chance to tax gains that have escaped tax previously.

The Blueprint eliminates gift and estate taxes with no replacement.

Key problems: business side

7. The Blueprint includes a border adjustment that probably violates World Trade Organization (WTO) rules and could lead to a successful challenge, resulting in punitive tariffs and other measures on United States exports.

WTO rules prohibit countries from providing subsidies to exporters or discriminating against imports as part of their income tax system. Unlike an indirect tax like a sales tax, excise tax, or VAT that burdens domestic and foreign producers alike, the House Blueprint is an income tax (a "direct tax") with a "border adjustment" that probably violates WTO rules. The border adjustment excludes foreign sales from the US tax base and disallows deductions for imported goods. At minimum, these aspects of the system could violate WTO rules on measures affecting trade in goods as well as rules prohibiting export subsidies.

While there is some legal uncertainty because the House proposal is short on details, many lawyers who have studied the issue carefully believe that one or more foreign trading partners would bring a WTO case against the US and would likely succeed. If that happens, the consequences would be harsh. Penalties could include billions of dollars or more in retaliatory tariffs against the United States. For context, in the late 1990s a U.S. tax measure that was relatively minor (compared to tax reform) was challenged at the WTO, and in 2003 the WTO authorized the EU to impose retaliation. After nine months of escalating EU tariffs on $4 billion in U.S. exports, Congress repealed the tax measure.

8. The "destination-based" system is risky, untested, and especially vulnerable to unforeseen consequences.

The Blueprint replaces our corporate tax system with a destination-based cash flow corporate income tax that is designed to mimic the economic consequences of a consumption tax or value-added tax (VAT). The intellectual origins of the plan can be traced primarily to David Bradford's X-tax (1977), and more recent academic work by Alan Auerbach and Michael Devereux. While the plan arguably works well *in theory* as an economic replacement for the corporate income tax, many more details need to be worked out before the House Blueprint could be considered a serious legislative option. It seems unlikely that the House will be able to accomplish this work effectively by working in secret without input from the tax policy community.

As discussed in more detail below, the Blueprint likely raises taxes on retailers and other net importers, while reducing taxes, possibly to zero, for Wall Street banks, insurance companies, and net exporters. The Blueprint will likely cause a change in asset prices, real estate values, currency values, and investment strategies in ways that are difficult to predict in advance; unlike European-style VATs, the policy community has not developed models or compiled a body of empirical evidence that could allow for a better understanding of the consequences. The Blueprint would also require significant work to fit into compliance with our network of bilateral tax treaties.

9. The Blueprint's impact on trade is unknown and probably unknowable.

The "border adjustment" element of the blueprint is, according to the House drafters, designed to equalize the tax treatment of foreign and domestic goods within the United States. The border adjustments would exempt exported goods from the tax base and would deny US firms any deduction for imported goods. The exemption of exported goods from the definition of sales is what makes the Blueprint a "destination-based" (not source-based) system. The denial of a deduction for imported goods reflects the fact that value added to goods that will be consumed here should be taxed here – again, reflecting a destination-based system. Unlike the border adjustments of VATs, however, the Blueprint would allow a deduction for domestic labor costs, favoring US-made goods and services over foreign-made goods and services.

Setting aside the WTO consistency of the border adjustment, some economists argue that the plan would ultimately have no effect on the trade balance. According to these economists, in response to the implementation of the tax, the dollar would strengthen against foreign currencies, making US exports less attractive and foreign imports more attractive until it all comes out in the wash.

Other economists have several concerns with this prediction: whether this economic prediction of currency adjustments would occur quickly; whether it would occur uniformly around the globe, and how it would interact with currencies that are more closely managed by government authorities. Nor do we understand if the currency adjustment would prevent trade balances from shifting across different industries. How businesses respond (e.g. whether imports shift from companies that pay U.S. corporate taxes to companies that do not) and how the measure is administered at the border also could significantly affect its impact on trading behavior, which could raise additional trade policy issues.

10. The Blueprint could disrupt stock prices.

The Blueprint creates a tax wedge between old assets (subject to depreciation) and new assets (full expensing) creating potentially large swings in asset prices, including stocks. Economists generally believe that a significant portion of the economic burden of the tax would fall on existing capital; this burden may or may not be offset by other features of the plan like rate changes and capital income preferences.

11. Consumer prices could skyrocket.

The Blueprint denies US firms a deduction for imported goods. Firms that rely heavily on imported goods would pass some of this cost along to consumers in the form of higher prices—potentially as much as 20 percent.

Increasing consumer prices would further exacerbate the regressive impact of the Blueprint; the lowest quintile of income earners can afford little in the way of savings and consumes nearly all income earned As with all consumption taxes, moreover, the Blueprint would have the economic effect of imposing a new tax on retirees who have already paid tax on their income and are now living off of savings.

Opposition is growing against the proposal from importers and others, including Koch Industries which came out against the proposal for leading to higher prices for consumers and ultimately “devastating” the economy.

12. The Blueprint may give Wall Street a free pass.

The Blueprint does not address the taxation of financial services, which represents about five percent of our total economy. Financial services are notoriously difficult to tax in consumption tax systems; European countries uniformly exempt financial services from the VAT or GST.

Financial services are intrinsically hard to tax in consumption tax systems because consumption tax systems usually exclude financial flows from the tax base. The Blueprint, too, generally excludes financial flows from its cash flow tax base. While, in theory, one could include financial flows in the tax base, doing so would mean that net borrowing would be taxable, a significant departure from current law that could inhibit business expansion.

So, assuming that financial flows are excluded from the tax base, a consumption tax system must distinguish between financial flows and "real" flows like the sale of goods and services. The problem is that financial services are often bundled together and priced into financial products like loans, mutual fund investments, and other equity investments.

For example, when you take out a mortgage to buy a house, oftentimes all of the related services (underwriting, loan servicing, etc.) are bundled together into your monthly payment. Now suppose you pay the bank $2000 for your monthly payment. How much of that amount should the bank include in its income?

This problem of real/financial "bundling" is particularly acute for financial services, but it is also a problem in areas like insurance, some derivative and hedging instruments, leasing, real estate, and trade receivables and other forms of seller-financed inventory.

13. The Blueprint may offer new opportunities for gamesmanship.

Under current law, income from U.S. sources is taxed currently, while income from foreign sources is taxed on a deferred basis—only when and if funds are repatriated to the United States in the form of a dividend. Many multinational corporations have been attacked for aggressively shifting U.S. income into offshore tax locations like Ireland and the Cayman Islands.

Instead of removing the incentive to shift income offshore, the Blueprint potentially opens up new opportunities to game the system by changing the tax base from worldwide income to U.S. sales. As a result, companies will now have a strong incentive to re-label U.S. sales as foreign sales—a problem that will be especially acute for transactions between multinational corporations.

14. The Blueprint's treatment of passthroughs could provide a new tax shelter for the rich.

Staff is concerned the Blueprint creates an incentive for anyone in the individual top bracket of 33% to incorporate their labor activities into a shell company and elect business tax treatment, thereby transforming what would otherwise be higher-taxed labor income into business income. It could also exacerbate the incentive that exists under current law to use S Corporations to avoid payroll tax liability.

It is unclear how passthrough entities (partnerships, S Corporations, REITs, RICs, etc.) would be taxed under the Blueprint. Passthrough business entities appear to be subject to the destination-based tax; but, under the usual passthrough principles, the business entity's tax liability would pass through to individual owners, who would face a top rate of 25% on such passthrough income. It is unclear how the partnership tax rules would be adapted to the new system; current law relies on a complex system to make sure that tax treatment of transactions reflect the underlying economics. The Blueprint does away with some features considered essential to partnership tax, like keeping track of an asset's tax basis, allowing a partner's share of partnership debt to increase tax basis, and so on. Over 90% of businesses are organized in some form of passthrough entity.

15. The Blueprint could cause tax-driven takeovers.

Net exporters would likely pay no tax under the Blueprint. In European systems, exporters receive a VAT rebate or refund when goods cross the border. Instead of paying out refunds to exporters, the Blueprint proposes that tax losses be carried forward indefinitely.

In order to use those losses, net exporters would be expected to seek mergers with net importers. Tax-driven distortions of the mergers and acquisition market are inefficient and can lead to unsuccessful mergers and wasteful tax planning. Even successful mergers can be bad for the average consumer; mergers can lead to greater concentration of market power and more extensive vertical integration of firms, reducing consumer welfare.

16. The Blueprint offers at best a partial solution to the international tax mess.

The Blueprint might be characterized as "territorial"-squared. It attempts to allow not only foreign-source income to avoid U.S. tax (like a territorial system), it also exempts U.S. source income that does not immediately result in U.S. sales or realization of individual-level financial returns. Individuals and companies may still have an incentive to engage in complex transactions and transfer pricing that shifts activity (on paper) into offshore tax havens, transforming what might otherwise be taxable U.S. business income into tax-advantaged offshore financial income.

17. The Blueprint would offer a sweetheart tax holiday on repatriated earnings.

Under current law, corporations that repatriate foreign source income to the U.S. pay tax at the normal U.S. corporate rate of 35%. The Blueprint offers a one-time repatriation rate of either 3.5% or 8.75% on offshore earnings, and future offshore activity would be excluded from the system. While many observers believe a lower rate is appropriate or perhaps necessary as a practical matter, most in the tax policy community would characterize the Blueprint's low rates on repatriation as a tax holiday rather than tax reform.

Addendum on Reconciliation

Budget reconciliation is inherently partisan and will not allow for careful consideration of the plan. Our concerns about the House Blueprint are amplified by the process under which it is likely to be considered. The budget reconciliation process was designed to make it easier for Congress to meet its budget goals, fast-tracking legislation through the Senate with limited debate and no filibuster. To ensure that the process is less subject to abuse, the Byrd rule allows Senators to raise a point of order striking, among other things, (1) provisions that have minimal budget effect and (2) provisions where the budget impact is merely incidental to the policy goal of the provision. The Blueprint legislation can be expected to have many such provisions, including tax administration and simplification provisions, certain excise taxes designed to change behavior, and provisions that streamline popular deductions and credits.

Budget reconciliation will not create lasting, sustainable tax reform. Budget reconciliation is designed for budget cuts and deficit reduction, not deficit expansion. The Byrd rule prohibits any reconciliation title from increasing the budget deficit in any year outside the budget window. The Blueprint would clearly increase the deficit, even with dynamic scoring. As a result, Republicans may choose to "sunset" the entire bill in 2027, with current law springing back to life in the first budget "out-year" (2028). The Budget reconciliation process is simply a poor fit for comprehensive tax reform; in the past it has led to such bizarre results as the complete repeal of the estate tax for one year (2010) followed by the estate tax springing back to life in the following year—better known in the tax policy community as the "Throw Momma From The Train" act. The budget reconciliation process leads to legislation that is temporary, non-comprehensive, and illogical. We would prefer that tax reform be comprehensive, lasting, and smart.

Conclusion

The House Blueprint leaves many questions unanswered. Some questions may be answered as the process moves forward. Other flaws seem to be intrinsic to the design. As the process moves forward in 2018 the Finance Committee staff would be happy to assist your work on any of these topics.