The Tax Rate Ratchet

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I. Introduction

The 2017 tax legislation[1] brought significant changes to the tax rates of the highest income Americans and especially the income they earn from businesses. The legislation dramatically reduced the top corporate rate from 35% to 21% and introduced the new Section 199A, providing a 20% deduction for qualifying business income earned through "pass-throughs." The legislation also redesigned the rules for taxing corporate income earned abroad, thereby reducing the incentives for corporations to take advantage of lower tax rates in foreign jurisdictions.

Reactions to these changes in the literature and the public discourse have been mixed. Many commentators have objected to the general distributional effect of these changes, which disproportionately benefit the highest income taxpayers.[2] These explicitly regressive effects of the legislation arguably shift the burden of the tax system in the wrong direction, at a time when more revenue from the wealthy—not less—is needed to adequately address the problems of economic inequality and long-term federal deficits. Other critiques have focused on the design problems with particular provisions in the legislation. Most notably, commentators (including ourselves) have critiqued the new Section 199A pass-through deduction for drawing arbitrary lines between economically similar activities and forms of income that divide the tax system into winners and losers and invite strategic gaming by well-advised taxpayers.[3] At the same time, other changes—such as the corporate rate cut and the international changes—have been applauded in many corners, as necessary to address pressures on the international tax system.[4]

This Article provides a new understanding of the structural problems with the 2017 tax legislation and its consequences for the progressive tax system. In particular, this Article describes the relationship *between* the design problems and distributional consequences of the legislation, and why this relationship suggests a different understanding of both. This relationship explains why the legislation will have distributional consequences beyond its explicit tax cuts for the wealthy, and why design critiques should focus on the problems with the corporate rate cut, rather than just on Section 199A.

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[1] Pub. L. No. 115-97, 131 Stat. 2054 (2017) [hereinafter *the 2017 tax legislation*].
[2] See *infra* note xx and accompanying text.
[3] *See, e.g.*, David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. (forthcoming); Daniel Shaviro, Evaluating the New U.S. Pass-Through Rules, 218 BRIT. TAX REV. 49 (2018).
[4] *See, e.g.*, Reuven S. Avi-Yonah, *How Terrible Is the New Tax Law?: Reflections on TRA17* 4 (University of Michigan Law and Economics Working Paper No. 148, 2018) ("On the corporate side, the main change is a long overdue reduction of the rate to 21%."); Nigel Chalk et al., *The Tax Cuts and Jobs Act: An Appraisal* 5 (IMF Working Paper No. 18/185, 2018) ("Most observers regard a cut in the statutory rate of corporation tax as long overdue.")

The key to this relationship between the design problems and distributional consequences of the 2017 tax legislation is what this Article terms "the tax rate ratchet"—a path dependence in the structure of the tax system whereby the significant reduction in the tax on corporate income leads to lower rates on other forms of income earned by individuals. The tax rate ratchet, if not "broken" or unwound, will impede future tax increases on the highest income Americans and the restoration of a more progressive tax system.

The tax rate ratchet may be explained intuitively as follows: The reduction in the corporate rate led to a commensurate tax preference for pass-through income, in the form of the Section 199A deduction. This preference for pass-through income, however, creates a new discontinuity between income qualifying for the deduction and other forms of income earned by individuals. In this context, Congress cannot increase the rates on these other forms of individual income without creating greater pressure along the discontinuity between these forms of income and preferenced income earned through pass-through and corporations. This structure thereby generates overall tax system constrained to less progressivity than would otherwise be socially optimal.

The tax rate ratchet may be explained more formally through the concept of the elasticity of taxable income.[5] Elasticity of taxable income measures the responsiveness of a taxpayer's reported income to changes in the tax rate, which may change as taxpayers adjust the form, substance, or reporting of their income-earning activities in response to the tax rate. The economics literature of the last several decades has described how this responsiveness can result from substitution across any number of discontinuities (or "margins") in the tax law that divide lightly-taxed or completely-untaxed activities or income from other higher-taxed activities or income.[6] In this respect, the tax rate ratchet increases the elasticity of taxable income, by creating new discontinuities across substitutable forms of income in the tax system. Elasticity of taxable income, in turn, affects the marginal social cost per dollar of revenue raised and the optimal maximum rate that may be applied to different forms of income. The greater the elasticity of taxable income, the greater the social cost of taxation, and the lower the optimal maximum rate that can be imposed on high earners.[7]

Because of the tax rate ratchet effect, the large cut in the corporate income tax rate increased the elasticity of taxable income throughout the individual income tax system. By lowering the corporate income tax rate so dramatically, the legislation opened the door for many non-corporate businesses to switch their organization form for tax purposes to escape the individual income tax and reduce their tax bills. That is, the corporate rate cut increased the elasticity of taxable income for all income that could be earned in the corporate form. This increased elasticity of taxable income in turn justified a further reduction in the effective individual income tax rates and will impede future efforts to significantly increase these rates.

The tax rate ratchet suggests a different understanding of the 2017 tax legislation and a counter-narrative to much of the expert commentary on the bill thus far. In particular, the tax rate ratchet relocates the bill's structural problems from Section 199A to the corporate rate cut. In the

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[5] For a good overview of the importance and limitations of the concept of the elasticity of taxable income, see generally Emmanuel Saez et al., "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," 50 J. ECON. LIT. 3 (2012).

[6] *Id.* at 5 ("The taxable income elasticity literature generalizes … by noting that hours of work are only one component of the behavioral response to income taxation. Individuals can respond to taxation through other margins such as intensity of work, career choices, form and timing of compensation, tax avoidance, or tax evasion.")

[7] *See id.* at 8 ("Therefore, the behavioral response elasticity is also a key parameter for characterizing optimal progressivity."). Importantly, though, one has to consider also any positive revenue effect of whatever activity taxpayers switch to, which reduces the net social cost of such substitution. *See id.* at 10-12.

view of many commentators, a reduction in the corporate rate—evaluated in isolation—was a desirable and uncontroversial reform.[8] Proponents argued that the cut was justified to address the broken international tax stem, which incentivized U.S. multinational corporations ("MNCs") to engage in tax planning and shift profits away from high tax jurisdictions like the United States and toward low tax ones.[9] Cutting the corporate rate in the United States—from 35% to 21%--was justified as a way to alleviate these global pressures.

The effect of cutting corporate rates, however, is not limited to MNCs responding to the global competition for profits. Under current tax rules, even small and wholly domestic entities—if properly structured—can take advantage of the low corporate rate. The large cut in the corporate rate thereby shifted the calculus for many more domestic companies and individuals on the decisional margin between taxation under the pass-through and corporate regimes. That margin may in fact turn out to be more important than the international one. At the very least, the direct connection to the domestic tax system has not been as fully appreciated in much of the expert commentary on the cut in the corporate rate.

Experts on both the left and the right have criticized Section 199A more harshly—and more unanimously—than the corporate rate cut. Theses critiques focused on the discontinuities this rule introduced among different forms of income and the gaming opportunities the rule presented for well-advised taxpayers.[10] Others deemed the rule unnecessary since businesses could switch to corporate form if they wanted to.[11]

The tax rate ratchet suggests a qualified defense of Section 199A, however, by evaluating the rule in a broader context of the large corporate rate reduction and the tax rate ratchet the corporate rate cut triggered. At the very least, the problem of Section 199A should be understood as derivative of the corporate rate reduction—a symptom rather than a disease. [12] In the face of a higher elasticity of taxable income, a rate reduction in some form on pass-through business income—especially focused on the kinds of activity most likely to shift from pass-through to corporate form—can plausibly be justified. Congress could have designed Section 199A better, but faced the inherently difficult task of defining some category of "business income" to preference on parity with similar income earned through a corporation. In this case—given Congress's ill-

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[8] *See supra* note 4.

[9] *See supra* Section II.C.

[10] *See supra* note 3. Sharp critics of the pass-through deduction include those who have generally praised the corporate rate reduction in the legislation. For instance, see Avi-Yonah, *supra* note, at 5 ("There is one big problem with TRA17: The passthrough provisions."); Chalk et al., *supra* note 4, at 19 ("It would be better not to have the 20 percent deduction for certain types of pass-through income."). That extends to conservative outlets which generally praised the approach of the 2017 legislation and especially the corporate rate reduction.

[11] *See e.g.* Chalk et al., *supra* note 4, at 19 ("It would be better not to have the 20 percent deduction for certain types of pass-through income. This would have ensured the highest tax rate for pass-throughs remains above that for distributed corporate profits, creating incentives for a broad range of entities to incorporate as C-corporations."); Scott Greenberg, "Should the Corporate Rate and the Pass-Through Rate Be Identical?," Tax Foundation, July 13, 2017 ("In the worst-case scenario, most pass-through businesses would be able to convert their legal form into a C corporation, to avoid being disadvantaged by tax reform.")

[12] Others too have, to some degree, recognized the dilemma created by the large cut in the corporate rate in the domestic tax system and the relationship to the pass-through deduction. This is the case especially in Daniel Shaviro's recent evaluation of the pass-through rules. Nonetheless, Shaviro concludes that the pass-through rules have a "complete lack of any plausible rationale," and argues that the corporate rate reduction can't justify them especially given other relatively easy changes that could be made to the tax system. We differ from that conclusion and believe that the tax rate ratchet is a phenomenon that both gives some rationale for provisions like Section 199A and requires larger moves to address, such as a significant increase in the corporate rate or fundamental shifts in the tax base. *See generally* Shaviro, *supra* note 3.

advised revenue and distributional targets—two preferences might be better than one in order to avoid inefficient changes to corporate status. More broadly, Section 199A should be understood as the natural effect of a low corporate rate on the individual income tax system, resulting in an effective—though indiscriminately applied—reduction in the top individual rate.

The tax rate ratchet also fundamentally challenges the wisdom of the corporate rate cut in the first instance. Simply stated, relieving pressure on the international tax system by dramatically cutting the corporate rate was likely not "worth it," given the collateral consequences elsewhere in the tax system. The tax rate ratchet illuminates the full costs of addressing these international pressures. Reducing the corporate tax rate—and consequently incurring theses costs in the domestic tax system—might have been warranted if the change in fact reduced multinational profit shifting by large quantities. Recent evidence suggests, however, that multinational profits aren't that sensitive to the kind of rate reduction just enacted.[13] For many multinationals, that reduction doesn't change the basic calculus—it would still make sense to locate profits in low- or no-tax jurisdictions.[14] The 2017 legislation is a case of a relatively small tail—the international margins—wagging the dog of the domestic tax system.

Of course, the 2017 tax legislation didn't invent the discontinuity between income earned by individuals and corporations. The interaction between the corporate and the individual tax systems in these earlier eras has been studied in great detail in the prior literature. Much of that literature, however, pre-dates both modern tax rules allowing many companies to freely choose to be taxed as corporations and also modern innovations in state law that alternated non-tax business incentives. These changes fundamentally changed the elasticity of the choice of business form, and therefore the effects of a corporate rate change on other parts of the tax system. Of course, this prior literature also predates the 2017 tax legislation itself, and the unique combination of rate discontinuities the bill introduced.

This Article updates the prior literature on the discontinuity between individual and corporate income through a focus on the 2017 tax legislation, and the new structural problems the bill introduced that have reshuffled the dynamic from prior eras. The tax rate ratchet links the corporate rate cut to other regressive changes in the 2017 tax legislation—including the pass-through deduction—and to a deeper structural threat to the progressive tax system.

The prior literature is instructive, however, in understanding the effect of the tax rate ratchet in the contemporary tax system. Economists analyzing a prior era of tax reform suggested that the 1986 Act reduced the elasticity of taxable income, by eliminating discontinuities and consistently treating taxable income earned through different forms.[15] This reduction in taxable income, in turn, arguably allowed for policymakers to *increase* rates through subsequent legislation, and thereby raise more revenue from wealthy taxpayers without generating high attendant social costs.[16] In this respect, the tax rate ratchet resulting from the 2017 tax legislation may be understood as an inverse effect of the dynamic resulting from the 1986 Act.

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[13] *See* Kimberly Clausing*, Profit Shifting Before and After the Tax Cuts and Jobs Act* (Working Paper, 2018) ("[Corporate income] tax elasticities are likely to be nonlinear, such that tax bases are more responsive to changes in tax rates at lower tax rates, and less responsive at higher tax rates.").

[14] *Id.*

[15] *See, e.g.*, Joel Slemroda and Wojciech Kopczuk, *The Optimal Elasticity of Taxable Income*, 84 J. PUB. ECON. 91, 106 ("[The Tax Reform Act of 1986] broadened the tax base and restricted the use of tax shelters, both of which arguably reduced the elasticity of taxable income.").

[16] *Id.* at 107 ("[O]ne could argue that, once the Tax Reform Act of 1986 was passed and policy makers became aware that the taxable income elasticity (and the marginal social cost of increasing progressivity) had declined, they appropriately increased the progressivity of the tax system by raising the top income tax rates in 1990 and 1993.").

The tax rate ratchet is not inevitable, as evidenced by the experience from prior eras of tax reform. This Article concludes by considering some of the possible avenues for policymakers to "break the ratchet" and alleviate the pressure generated by the corporate system on the individual income tax. One direction is to simply revert to the prior relationship between the individual and corporate systems: a system that tended to penalize corporate form for tax purposes and thus isolate the corporate system to the largest companies that were required to use it since they were publicly traded. This imperfect approach may have ultimately been more desirable, and less costly, than the structural problems resulting from the 2017 bill. This approach could have also minimized theses costs in other ways, through expanded base protection measures in the international system to further reduce the ability of corporations to substitute across that margin.

An alternative direction would break the ratchet through fundamental reforms that have long been on the list of proposals to rationalize and improve the structure of the tax system. For instance, policymakers could break the ratchet by integrating the between the individual and corporate tax systems, which would eliminate the discontinuities between the taxation of different forms of income. In the case of the 2017 tax legislation, Congress instead chose to preserve the current structure distinguishing between corporate and individual income. This choice ultimately constrained Congress to accept pressures in the domestic tax system as a cost of their corporate cut to address international pressures. In this respect, this Article's account of the tax rate ratchet and the structural effects of the 2017 tax legislation bring a new perspective to the prior integration literature, and a new urgency to this alternative possible direction for the tax system.

The remainder of this Article proceeds as follows. Part II begins by describing the 2017 tax legislation, the contemporaneous story that was told explaining this particular package of changes, and the most salient critiques (and defenses) of the legislation in the prior literature. Part III then introduces the tax rate ratchet and describes its effect in the 2017 tax legislation. In particular, this Part explains why the elasticity of taxable income matters and how it varies with tax rules, and how this concept provides a frame for understanding the real structural problems with the 2017 tax legislation. Part IV considers policy options to "break the ratchet" and thereby reduce pressures on the domestic tax base and facilitate progressive taxation at the top of the distribution. Part V concludes.