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Tax Reform Isn't Done

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Summary

- In December 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), arguably the most significant piece of tax legislation in three decades. However, there remains more work to be done on improving the U.S. tax code.

- A number of major provisions in TCJA are scheduled to expire over the next eight years. Many of the expiring provisions should instead be made permanent, ideally sooner rather than later. At the same time, lawmakers should also take the opportunity to evaluate which portions of TCJA ought to be improved.

- In 2021 and 2022, several policy changes are scheduled to take place which would raise taxes on U.S. business investment. Lawmakers should consider options to avert or modify these scheduled tax increases.

- In 2025, most of the individual income tax changes in TCJA are set to expire. When deciding which of these to make permanent, Congress should prioritize those that broaden the individual income tax base, as well as those that make the tax code simpler and more neutral.

- More broadly, TCJA did not address every area of the federal tax code in need of reform. In the future, lawmakers should scale back remaining tax expenditures, reform the tax treatment of household saving, and provide greater cost recovery for structures.

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Introduction

When it comes to reforming the federal tax code, there is still more work to be done.

The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, made several significant changes to the federal income tax.[1] The bill reduced tax rates for both corporations and individuals, limited major deductions, and created a new set of rules for companies that earn income overseas.

However, TCJA also created a number of open questions about the future of the federal tax code. For one thing, vast portions of the bill are set to expire or change over the next eight years. In 2021 and 2022, several provisions are scheduled to take effect which would raise taxes on business investment in the United States. Then, at the end of 2025, nearly all of the individual income tax changes in the bill are set to expire, meaning that most U.S. households would owe more in taxes the following year.

As a result, there is still more work to be done to resolve the uncertainty about what the federal tax code will look like in eight years. Sooner or later, Congress will be faced with the choice of which of the temporary provisions in TCJA should be allowed to expire, and which should be made permanent.

More generally, there remain many areas of the federal tax code that are prime targets for reform, but were not addressed fully by TCJA. For instance, the tax code continues to disadvantage business investment in structures relative to other categories of business spending, and the tax treatment of household saving continues to be confusing and poorly designed. Furthermore, the tax code still contains dozens of "tax expenditures," provisions that offer preferential treatment to favored economic activities.

In other words, there is still more work to be done to make the federal tax code simpler, more neutral, and more efficient. Congress should begin thinking now about further improvements that could be made to the federal tax code in the future.

1 Technically, the final title of the recent tax bill was "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." However, the bill is commonly referred to as the Tax Cuts and Jobs Act, which was the bill's title through most of the legislative process.

Overview of Scheduled Upcoming Tax Changes

The most immediate topic of concern regarding the future of the federal tax code is the multitude of provisions in the Tax Cuts and Jobs Act that are scheduled to expire or change over the next eight years.

The following chart summarizes the most important scheduled upcoming tax changes that lawmakers and taxpayers should be aware of:

TABLE 1.

Major Scheduled Changes in Federal Tax Law

Businesses will be required to deduct research and experimentation costs over five years, rather than immediately	After the end of 2021
The deduction for business net interest expense will be limited to 30% of EBIT, rather than 30% of EBITDA	After the end of 2021
Full expensing for short-life business investments will begin phasing out	After the end of 2022
The reduction of individual income tax rates will expire	After the end of 2025
The increase in the standard deduction, elimination of the personal exemption, and doubling of the child tax credit will expire	After the end of 2025
Limits on the state and local tax deduction and the mortgage interest deduction will expire	After the end of 2025
The reduction of the alternative minimum tax will expire	After the end of 2025
The newly created pass-through deduction (§199A) will expire	After the end of 2025
Three international-related provisions (GILTI, FDII, and BEAT) will become more restrictive	After the end of 2025
The reduction of the estate tax will expire	After the end of 2025

The details of each of these scheduled tax changes are as follows:

1. Amortization of research and experimentation costs

Currently, when a company spends money on research or experimentation, it is allowed to deduct the full cost of the expense immediately.[2] This ability of businesses to expense their research and development (R&D) investments has been a part of the federal tax code since at least 1954.[3]

However, under TCJA, in tax years after December 31, 2021, companies that invest in research and experimentation will generally be required to deduct these investment costs over a period of five years.[4] This change would raise the cost of making research investments in the United States, and would increase the tax burden on businesses that spend money on R&D. The change is expected to raise $120 billion in revenue between 2022 and 2027.[5]

2 26 U.S.C. §174.

3 Gary Guenther, "Research Tax Credit: Current Law and Policy Issues for the 114th Congress," Congressional Research Service, March 13, 2015.

4 P.L. 115-97, §13206.

5 Joint Committee on Taxation, "Estimated Budget Effects of The Conference Agreement For H.R. 1, The 'Tax Cuts and Jobs Act'," December 18, 2017, JCX-67-17.

2. Limitation on interest deductibility based on 30 percent of EBIT

Prior to the enactment of TCJA, businesses were generally allowed to deduct their total amount of interest paid, subject to a few minor limitations. One of the central provisions in TCJA was the creation of a new limit on the deduction for business interest paid, intended to reduce the tax code's preference for debt over equity.[6] Starting in 2018, companies generally are no longer allowed to deduct net interest in excess of 30 percent of their "adjusted taxable income."[7] However, the definition of "adjusted taxable income" is scheduled to change after December 31, 2021.

Until the end of 2021, "adjusted taxable income" is defined in a manner similar to the EBITDA income concept: a broad measure of a business's income, which doesn't take into account how much investment-related deductions a business claims.[8] This means that the threshold for hitting the limitation on interest deductibility will be relatively high (30 percent of a broad income concept), and that businesses that invest more won't be in greater danger of hitting the threshold.

But after 2021, the limit on the deduction for net business interest is scheduled to become significantly tighter. This is because the definition of "adjusted taxable income" is scheduled to switch to one similar to the EBIT income concept: a narrower measure of a business's income, which subtracts out businesses' investment-related deductions.[9] As a result, after 2021, the threshold for hitting the limitation on interest deductibility will become lower (30 percent of a narrow income concept), and businesses that invest more could be at greater risk of hitting the threshold.

As a consequence of this shift, the limitation on interest deductibility is anticipated to raise significantly more federal revenue after 2021 than it does initially. Between 2018 and 2021, the limitation is expected to raise $16.4 billion a year, on average; between 2022 and 2027, that figure jumps to an average of $31.4 billion a year.[10]

3. Phaseout of 100 percent expensing for short-life business investments

One of the most significant provisions in TCJA, often referred to as "full expensing," would allow businesses to immediately deduct the full cost of most short-life business investments, such as equipment and machinery.[11] However, the provision is scheduled to begin phasing out after December 31, 2022.

6 See Alan Cole, "Debt and Taxes," *American Affairs* II(1), Spring 2018.

7 P.L. 115-97, §13301. The new interest deduction limitation contains several exceptions, including for small businesses, auto dealers, electing real estate businesses, and electing farmers.

8 "EBITDA" stands for "earnings before interest, taxes, depreciation, and amortization."

9 "EBIT" stands for "earnings before interest and taxes."

10 Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1."

11 P.L. 115-97, §13201.

To understand the import of this provision, some background may be useful. When calculating their income for tax purposes, companies are generally allowed to deduct the full cost of their ordinary and necessary business expenses, in the year those expenses are made.[12] However, a different set of rules applies when it comes to businesses' capital investments – such as equipment, machinery, and buildings. Businesses are not generally allowed to deduct the full cost of these expenses immediately. Instead, they are required to deduct these investment costs over time, following a set of depreciation schedules.[13]

Full expensing does away with the need for depreciation schedules and simply allows businesses to deduct the cost of their investments immediately, as they would with any other business expense. In the case of TCJA, the full expensing provision applies to most short-life investments, not to longer-lived assets like buildings.[14] The effect of the provision is to lower the cost of investing in the United States.

Full expensing for short-life investments is set to gradually phase out after December 31, 2022. In tax year 2023, for instance, businesses would only be able to deduct 80 percent of the cost of their short-life investments; in 2024, the percentage would fall to 60 percent; and so on, until the provision expires entirely at the end of 2026. The phaseout of the provision would increase the cost of domestic investment in equipment and machinery.

4. Expiration of the individual income tax rate reductions

One of the largest tax changes that is scheduled to expire at the end of 2025 is the reduction of individual income tax rates for households.[15]

Before TCJA was passed, the federal individual income tax was levied at seven rates, ranging from 10 percent to 39.6 percent. The new rate schedule created by TCJA preserved the same number of brackets, but lowered several of the rates substantially. The bill also reconfigured the thresholds and widths of several of the brackets, with the effect of reducing the size of marriage penalties arising from the tax bracket structure.

12 26 U.S.C. §162.

13 26 U.S.C. §167.

14 See 26 U.S.C. §168(k).

15 P.L. 115-97, §11001.

TABLE 2.

Individual Income Tax Rates and Thresholds, 2018, Prior Law and Current Law

Prior law, 2018			Current law, 2018		
	Single	Joint		Single	Joint
10%	$0-$9,525	$0-$19,050	10%	$0-$9,525	$0-$19,050
15%	$9,525-$38,700	$19,050-$77,400	12%	$9,525-$38,700	$19,050-$77,400
25%	$38,700-$93,700	$77,400-$156,150	22%	$38,700-$82,500	$77,400-$165,000
28%	$93,700-$195,450	$156,150-$237,950	24%	$82,500-$157,500	$165,000-$315,000
33%	$195,450-$424,950	$237,950-$424,950	32%	$157,500-$200,000	$315,000-$400,000
35%	$424,950-$426,700	$424,950-$480,050	35%	$200,000-$500,000	$400,000-$600,000
39.6%	$426,700+	$480,050+	37%	$500,000+	$600,000+

This new bracket schedule will reduce individual income taxes substantially for households across the income spectrum. In fact, the individual rate cuts were the largest single tax reduction included in TCJA, lowering federal revenue by $1.16 trillion between fiscal years 2018 and 2025.[16]

After December 31, 2025, the individual income tax rate schedule is set to revert to the pre-TCJA brackets and rates. Should this occur, many households would see their taxes go up significantly in 2026.

5. Expiration of the increase in the standard deduction, the elimination of the personal exemption, and the increase of the child tax credit

Prior to the enactment of TCJA, the federal tax code included three major provisions that reduced households' income taxes in proportion to the number of household members: the standard deduction, the child tax credit, and the personal exemption. Under TCJA, these three provisions were consolidated into two: the personal exemption was eliminated, replaced by an expanded standard deduction and child tax credit. However, all of these changes are set to expire at the end of 2025.

More specifically: under TCJA, the standard deduction was increased from $6,500 to $12,000 for singles and from $13,000 to $24,000 for married joint filers.[17] The maximum child tax credit amount was increased from $1,000 per child to $2,000 per child, with a new addition of up to $500 for each non-child dependent.[18] And the personal exemption, which had previously allowed households to reduce their taxable income by $4,150 for each filer and dependent, was eliminated.[19]

16 Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1."

17 P.L. 115-97, §11021. Dollar amounts represent 2018 tax parameters.

18 P.L. 115-97, §11022. The bill made a number of other changes to the child tax credit, including raising the phaseout threshold, lowering the phase-in threshold for the refundable portion of the credit, and limiting the refundable portion of the credit to $1,400 per child.

19 P.L. 115-97, §11041.

In terms of federal revenue, these three changes will more or less cancel each other out. Over the next eight years, the increased standard deduction will reduce federal revenue by $690 billion, the elimination of the personal exemption will raise $1.16 trillion in revenue, and the expansion of the child tax credit will reduce revenue by $474 billion.[20] In total, these three provisions together will reduce federal revenue by $4.2 billion between fiscal years 2018 and 2025, a negligible amount.

TABLE 3.

Revenue Effects of Changes to the Standard Deduction, Personal Exemption, and Child Tax Credit, Fiscal Years 2018-2025

Increase the standard deduction	-$690.4 billion
Eliminate the personal exemption	$1,160.3 billion
Increase and expand the child tax credit	-$474.1 billion
TOTAL	-$4.2 billion

Source: Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act'," December 18, 2017, JCX-67-17.

Despite having little net effect on federal revenue, these three changes are consequential for the structure of the individual income tax. For instance, due to the increase in the standard deduction, it is likely that far fewer households will choose to itemize deductions in coming years – which would simplify the tax filing process, and would steer taxpayers away from provisions that subsidize specific economic activities.[21] Additionally, in combination, these three changes reduce taxes on lower-middle-income households, while raising them on upper-income filers.[22]

All three changes are set to expire after December 31, 2025: the personal exemption would be reinstated, while the standard deduction and child tax credit would be reduced. This would have the effect of raising taxes on lower-middle-income households, cutting taxes on upper-income households, and leading more taxpayers to itemize deductions.

6. Expiration of limits on the state and local tax deduction and the mortgage interest deduction

In recent years, the two largest itemized deductions available to households have been the deduction for state and local taxes paid and the deduction for mortgage interest paid.[23] Previously, the state and local tax deduction was essentially unlimited, while the mortgage interest deduction was limited to interest paid on $1 million of home acquisition debt and $100,000 of home equity debt.[24]

20 Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1."

21 See Tax Policy Center, "T18-0004 – Impact on the Tax Benefit of Itemized Deductions of H.R.1, The Tax Cuts and Jobs Act (TCJA), By Expanded Cash Income Percentile, 2018," January 11, 2018.

22 The intuition for why this is the case is as follows. First, consider tax benefits for dependents. For households in the 10 percent, 12 percent, and 22 percent brackets, the value of the increased child tax credit (up to $1,000 per child) is larger than the value of the lost personal exemption for children (up to $415, $498, or $913 per child, for households in these three brackets). This is not always the case for households in higher brackets. Second, consider tax benefits for filers. For households that took the standard deduction prior to TCJA, the increase in the standard deduction is worth more than the loss of the personal exemption for filers. For households that itemized prior to TCJA (generally higher-income households), this is not always the case. In particular, households that itemized prior to TCJA and will still itemize under the new law will lose $8,300 of personal exemptions for filers without gaining any benefit from the increased standard deduction.

23 See Department of the Treasury, "Tax Expenditures," October 16, 2017, https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2019.pdf.

24 26 U.S.C. §163(h)(3).

Under TCJA, both deductions are subject to new limits. The state and local tax deduction is limited to $10,000 per household, while the mortgage interest deduction is limited to interest paid on $750,000 of home acquisition debt (interest on home equity debt is no longer deductible).[25] These two limits will broaden the individual income tax base significantly: between fiscal years 2018 and 2025, the changes to itemized deductions in TCJA are expected to raise $627.3 billion in federal revenue.[26]

The effect of these provisions will be to reduce tax preferences for homeownership and for high-tax states and localities. The households most likely to be affected by the limits are upper-middle-income and high-income households, who are more likely to itemize deductions, more likely to own homes worth more than $750,000, and more likely to pay over $10,000 in state and local taxes.[27]

However, both of these limits are scheduled to expire after December 31, 2025. The expiration of these limits would narrow the federal tax base and reduce revenue significantly, while expanding tax preferences for upper-income households in high-tax states and upper-income households that own homes.

7. Expiration of the higher alternative minimum tax exemption

The alternative minimum tax (AMT) is a provision which requires some upper-income households to calculate their taxes twice, under two sets of rules, and to pay whichever amount is higher.[28] The intent of the provision is to prevent households from receiving excessive benefit from tax preferences, although it adds an additional layer of complexity for the roughly 10 million households that go through the AMT calculation every year.[29]

Under TCJA, the AMT exemption amount is increased significantly, as well as the threshold for the phaseout of the AMT exemption.[30] In effect, this means that vastly fewer households will be subject to the AMT over the coming years.[31] However, this change is set to expire after December 31, 2025, meaning that far more households would be subject to the AMT.

25 P.L. 115-97, §11042, §11043.

26 Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1." This revenue estimate includes minor revenue effects from other changes to itemized deductions as well, such as the elimination of the miscellaneous itemized deductions in §67.

27 For instance, a recent estimate from the Tax Policy Center implies that over 80 percent of households hit by the $10,000 cap on the state and local tax deduction are in the highest income quintile. See Tax Policy Center, "T17-0338 - Repeal $10,000 Limit on Deductible State and Local Taxes, Baseline: Law after Enactment of H.R.1, The Tax Cuts and Jobs Act, Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2018," December 21, 2017.

28 26 U.S.C. §55

29 See Scott Greenberg, "Four Million Taxpayers are Subject to the AMT. Who Are They?" Tax Foundation, March 4, 2016.

30 P.L. 115-97, §12003.

31 The Tax Policy Center estimates that, under TCJA, only 0.2 million households will be subject to the AMT between 2018 and 2025, compared to 6.0 million households in 2026. However, a portion of the reduction in the number of households subject to the AMT is also due to the new cap on the deduction for state and local taxes paid. See Tax Policy Center, "T17-0338."

8. Expiration of the deduction for pass-through business income (§199A)

Most businesses in the United States are "pass-through businesses": they are not subject to the corporate income tax, but instead have their income taxed on their owners' individual income tax returns.[32] One major change in TCJA was the creation of a new temporary deduction (section 199A) for households that receive income from pass-through businesses, which is set to expire after December 31, 2025.[33]

Previously, income from pass-through businesses had been subject to the same rate schedule as other personal income, such as wages and salaries. For instance, prior to the enactment of TCJA, a household earning $100,000 of self-employment income would pay the same amount of income tax as a household earning $100,000 of wages and salaries.

Under the new section 199A deduction, income from pass-through businesses is now generally subject to tax rates that are effectively 20 percent lower than the rates that apply to other income. For instance, instead of being taxed at a top rate of 37 percent like wages and salaries, the section 199A deduction effectively allows qualifying pass-through business income to be taxed at a top rate of 29.6 percent.

That said, the deduction is subject to several complex limitations which restrict the benefit of the provision for high-income households. For instance, households making over $157,500 (or $315,000 if married filing jointly) are not eligible to claim the full deduction on income from service businesses, such as law firms and medical practices. Despite these limitations, many tax experts have expressed concern that the new deduction will facilitate widespread tax avoidance and gaming.[34]

After 2025, households with pass-through business income would no longer be able to claim the section 199A deduction. This scheduled change would raise taxes on households with pass-through business income, increasing federal revenue. In addition, the expiration of the section 199A deduction would decrease the complexity of the federal tax code, remove the preferential treatment of pass-through business income relative to other personal income, and reduce opportunities for tax avoidance.

32 For additional background, see Scott Greenberg, "Pass-Through Businesses: Data and Policy," Tax Foundation, January 17, 2017.

33 P.L. 115-97, §11011.

34 Jim Tankersley, "Kansas Tried a Tax Plan Similar to Trump's. It Failed.," *The New York Times*, October 10, 2017; Kamin et al., "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation," *SSRN Electronic Journal*, December 13, 2017.

9. Increased tax rates on businesses with foreign-source income

As part of an extensive overhaul of the rules for U.S. companies that earn foreign-source income, TCJA created several new provisions that apply to multinational businesses. One provision, known as GILTI (the inclusion of "global intangible low-taxed income") is designed to apply current-year tax to U.S. corporations that earn high-margin profits in low-tax overseas jurisdictions.[35] Another, known as FDII ("foreign derived intangible income"), is designed to offer a lower tax rate to U.S. corporations on their foreign income derived from intangible assets held in the United States.[36] A third provision, known as BEAT (the "base erosion and anti-abuse tax"), applies an alternative minimum tax calculation on companies that make substantial "base erosion payments" from the U.S. to foreign affiliates.[37]

All three provisions are scheduled to become more restrictive after December 31, 2025. The tax rate on high-margin foreign profits, under GILTI, is scheduled to rise from 10.5 percent to 13.125 percent. The reduced rate on foreign profits derived from U.S. intangibles, under FDII, is scheduled to increase from 13.125 percent to 16.406 percent. And the rate at which the BEAT is levied on multinational companies is scheduled to go up from 10 percent to 12.5 percent.

10. Expiration of the increased estate tax exclusion

The federal estate tax is levied at a rate of up to 40 percent on the total value of a deceased person's estate above a certain threshold, minus certain deductions.[38] The threshold at which the estate tax begins to apply is known as the estate tax exclusion, and was $5.49 million per person in 2017.[39]

Under TCJA, the estate tax exclusion was doubled, to $11.2 million per person in 2018.[40] This will reduce the number of people subject to the estate tax, as well as reducing the amount of estate tax paid by those still subject to it. However, this change is set to expire after December 31, 2025.

35 P.L. 115-97, §14201.
36 P.L. 115-97, §14202.
37 P.L. 115-97, §14401.
38 26 U.S.C. §2001
39 Internal Revenue Service, Rev. Proc. 2016-55.
40 P.L. 115-97, §11061.

Stabilizing a Temporary Tax Code

One of the central questions about all of these scheduled tax changes is whether Congress will actually allow them to occur. After all, federal lawmakers have a long track record of preventing the expiration of temporary tax provisions.

Consider the Bush tax cuts, for instance, which were passed on a temporary basis in 2001 and 2003.[41] At the end of 2010, Congress extended the Bush tax cuts for two additional years, passing the extension only two weeks before the cuts were scheduled to expire.[42] Then, at the very beginning of 2013, Congress passed the American Taxpayer Relief Act of 2012, which made about 82 percent of the Bush tax cuts into permanent law, according to one estimate, allowing the other 18 percent to expire.[43]

It is possible that lawmakers will adopt a similar approach to the temporary provisions in TCJA, and likely that Congress will take action to prevent at least some of these provisions from actually expiring. Indeed, the recent budget released by the Trump administration assumes that all the individual income tax changes that are set to expire in 2025 will instead be extended (although it makes no similar assumption about the business tax changes that are scheduled to occur in 2021 and 2022).[44]

As a result, there is a considerable amount of uncertainty about what the federal tax code will actually look like eight years from now. This situation – in which the federal tax code is fundamentally unstable in the medium term – is far from ideal.

Ideally, taxpayers making economic decisions would be able to predict with reasonable certainty what the tax consequences of their choices will be. But temporary provisions undermine taxpayer certainty, by making it difficult for businesses and households to anticipate whether specific tax provisions will be in effect in the future.

Imagine, for instance, a company deciding whether to build a new research laboratory in the United States. Normally, the company would calculate the expected after-tax profits from the laboratory, to determine if it would be a worthwhile investment. But because of the uncertainty about the future of the federal tax code, the company could be left with many key unanswered questions in the calculation.

41 P.L. 107-16; P.L. 108-27.

42 P.L. 111-312.

43 Chye-Ching Huang, "Budget Deal Makes Permanent 82 Percent of President Bush's Tax Cuts," Center on Budget and Policy Priorities, January 3, 2013.

44 Office of Management and Budget, "Federal Receipts: Governmental Receipts," *Analytical Perspectives*, "https://www.whitehouse.gov/wp-content/uploads/2018/02/ap_11_receipts-fy2019.pdf.

Perhaps the company is a pass-through business, and has no idea whether it will be able to claim the section 199A deduction on the profits from the laboratory in 2026 and beyond. Maybe the company intends to use the laboratory to ramp up its research spending in the future, but doesn't know if it will be able to fully deduct the money it spends on research after 2021. And perhaps the company already has a lot of debt, and is worried about whether investing in the laboratory could push it over the threshold for the interest deductibility limit, due to uncertainty about whether the calculation will be based on EBITDA or EBIT in 2022.

Until Congress makes a conclusive determination about which of the scheduled tax changes in TCJA will actually occur, businesses and households will face persistent uncertainty when making long-term economic decisions. As such, it would be good if congressional lawmakers could settle the status of the temporary provisions in TCJA as soon as possible – rather than waiting until the last minute, as Congress so often does.[45]

In the coming months and years, lawmakers should carefully review the parts of the tax code that are scheduled to change, and should set priorities for which temporary provisions in TCJA are most important to make permanent. Indeed, if there is any silver lining to all of these temporary provisions, it is that they will give Congress the chance to revisit the federal tax code over the coming decade and the opportunity to improve on the portions of TCJA that may have been lacking.

Policy Considerations for Changes in 2021 and 2022

The first round of scheduled tax changes under TCJA will occur in 2021 and 2022, when several business tax provisions are set to go into effect:

- After 2021, businesses will be required to deduct research and experimentation costs over five years, rather than being able to deduct the full cost immediately.
- After 2021, the limit on business interest deductibility will switch from a calculation based on 30 percent of EBITDA to one based on 30 percent of EBIT.
- After 2022, full expensing – a provision that allows businesses to immediately deduct the full cost of most equipment and machinery – is scheduled to start phasing out.

All three of these changes would raise federal revenue, helping to offset the overall fiscal cost of the tax bill. However, all three changes would also have the effect of making business investment in the U.S. more costly, with potentially negative economic consequences.

When determining how to approach the scheduled tax changes in 2021 and 2022, there are a number of considerations that lawmakers should keep in mind:

45 See Amber Phillips, "Why does Congress wait until the last minute to do (what seems like) everything?" *The Washington Post*, December 17, 2015.

Amortization of research and experimentation costs

Currently, research and experimentation probably receive the most favorable tax treatment of any category of business expenses.[46] This is because businesses are not only allowed to deduct their research expenses immediately, but are also able to claim a sizable research and experimentation credit.[47]

That said, there is a good reason why research expenses receive such favorable tax treatment: private research spending leads to new knowledge and innovation, creating positive externalities for the economy as a whole.[48] To the extent that private businesses are not able to capture all of the value that results from their R&D spending, it is appropriate that the federal government provide a subsidy to encourage and reward this activity.

Requiring businesses to deduct their research and experimentation costs over five years would likely have a negative economic effect, by increasing the cost of investing in research in the U.S. This change would also make the tax code more complicated, forcing businesses to track yet another set of deductions over multiple years, rather than simply being able to deduct expenses in the year that they occur.[49]

One straightforward option for lawmakers would be to simply cancel the scheduled requirement that businesses amortize their R&D expenses over five years, and allow businesses to continue deducting their research costs immediately. If lawmakers are concerned about the revenue loss from this option, they could accompany it with other changes that broaden the federal tax base.

Limitation on interest deductibility based on 30 percent of EBIT

The new limitation of business interest deductibility is one of the more promising provisions in TCJA. For many years, the federal tax code had offered substantially better tax treatment for businesses that finance their operations with debt, rather than equity.[50] This feature of the tax code led to distortions in business decision-making, causing companies to take on excessive amounts of debt due to tax considerations.[51] To address this issue, the new limit on interest deductibility is designed to scale back the tax benefit of debt-financing for the most highly-leveraged businesses.[52]

46 See, for instance, Table 9 of Leonard Burman, et al., "An Analysis of Governor Bush's Tax Plan," Tax Policy Center, December 8, 2015.

47 26 U.S.C. §41.

48 See Jason Furman, "Encouraging Innovation and the Role of Tax Policy," Joint International Tax Policy Forum & Georgetown University Law Center Conference, March 11, 2016, https://obamawhitehouse.archives.gov/sites/default/files/docs/20160311_innovation_and_tax_policy_itpf.pdf

49 That said, businesses do have the option under current law to amortize their R&D expenses over five years; for these businesses, this change would not increase the tax code's complexity.

50 Specifically, prior to TCJA, equity-financed corporate investment was subject to up to two layers of tax, while debt-financed investment was subject to up to one layer of tax. See Alan Cole, "Interest Deductibility – Issues and Reforms," Tax Foundation, May 4, 2017. Prior to TCJA, there were some cases in which interest flows were subject to a single layer of tax – deductible when paid and taxable when received. However, in practice, many recipients of interest income were not subject to U.S. federal income taxes (e.g. foreign bondholders, tax-exempt organizations). This meant that some interest payments were deductible when paid and not taxable when received, effectively creating a hole in the federal tax code.

Earlier tax reform proposals were even more ambitious, eliminating interest deductibility altogether, but also lowering tax rates on interest income received. This would have been an even better way to tackle the problem of the tax treatment of interest.

51 See, for instance, Deen Kemsley and Doron Nissim, "Valuation of the Debt Tax Shield," *The Journal of Finance* 57(5), October 2002, 2045-2074.

52 The design of the new limit is not perfect, as it will subject some interest flows to double taxation. Ideally, a limit on interest deductibility would have concentrated on disallowing business deductions for interest payments that are not subject to taxation when received.

As such, the fact that the limit on interest deductibility is scheduled to tighten in 2022 is not itself a cause for concern. However, it is worrying that the limit is set to switch to being based off of business EBIT, rather than EBITDA.

An interest deductibility limit based on EBIT could have some unintended consequences. For instance, the more capital investments a business makes, the lower the business's EBIT would fall. As a result, businesses with higher investment levels would be at greater risk of being subject to the "30 percent of EBIT" threshold; this could have the perverse effect of discouraging business investment. The general issue here is that the businesses with the most legitimate cause to issue debt are those that are pursuing new investments – but these businesses would be the ones most restricted from interest deductibility under a cap based on EBIT.

Luckily, there are many options for lawmakers to replace the scheduled switch to an EBIT-based limit with other changes to tighten the cap on interest deductibility. For instance, instead of allowing the business net interest deduction to be capped at "30 percent of EBIT," lawmakers could simply substitute a limit on net interest deductibility above "15 percent of EBITDA," which would probably raise a similar amount of federal revenue.

Phaseout of full expensing for short-life assets

Full expensing for short-life assets is one of the most important provisions to be included in TCJA. This is because full expensing fixes the fundamental bias against business investment in the federal tax code: the fact that most business expenses can be deducted immediately but capital expenditures are required to be deducted over long time periods. Expensing is also a major simplification of the tax code, allowing companies to simply deduct their costs in the year they are made, rather than having to sort through dozens of depreciation schedules.

Many economists consider full expensing to have even larger positive economic effects than reducing the corporate statutory tax rate, because the entirety of the tax change is focused on incentivizing businesses to engage in new investment.[53] Indeed, there is empirical evidence showing that businesses respond to expensing by significantly increasing their capital investment levels.[54]

Congress should make it a top priority to make full expensing a permanent part of the federal tax code, rather than allowing the provision to phase out after 2022.

53 Kyle Pomerleau, "Why Full Expensing Encourages More Investment than A Corporate Rate Cut," Tax Foundation, May 3, 2017.

54 Eric Zwick and James McMahon, "Tax Policy and Heterogeneous Investment Behavior," *American Economic Review* 107(1), 2017, 217-248; Giorgia Maffini et al., "The impact of investment incentives: evidence from UK corporation tax returns," Oxford University Centre for Business Taxation, January 2016.

Policy Considerations for Changes in 2025

The second round of scheduled changes to TCJA is the expiration of numerous provisions after December 31, 2025, including most of the individual income provisions in the bill. After 2025:

- The individual income tax rate schedule is set to revert to the pre-TCJA rates and thresholds.
- The standard deduction and the child tax credit would be reduced, while the personal exemption would be reinstated.
- The new limits on the state and local tax deduction and the mortgage interest deduction are set to expire.
- The AMT exemption is scheduled to be reduced, causing more households to be subject to the AMT.
- The new deduction for households with pass-through business income is set to expire.
- Three international provisions (GILTI, FDII, and BEAT) are scheduled to become more restrictive.
- The estate tax exclusion would be reduced, causing more households to be subject to the estate tax.

There are several considerations that lawmakers will have to take into account when determining which of these provisions to make permanent and which to allow to expire.

Perhaps the most fundamental question that lawmakers will have to determine is how large a change in federal revenue they are willing to accept for 2026 and onward. After all, most of the provisions that are set to expire after 2025 are tax cuts; if all of these expirations were allowed to go into effect, the result would be a significant net tax increase for taxpayers in 2026. On the flip side, lawmakers concerned about federal deficits may be counting on this scheduled revenue increase, and may be reluctant to extend a large net tax cut indefinitely.

Lawmakers should also evaluate which of these expiring tax provisions add to the simplicity, efficiency, and neutrality of the federal tax code. In doing so, they should pay particularly close attention to provisions that affect the federal income tax base. After all, tax rates have historically swung up and down as different parties gain political control, but changes to the tax base tend to be more long-lasting and more significant.

Without going into detail on every scheduled change in 2025, here are a few considerations that lawmakers should keep in mind when determining how to approach the expiring provisions in that year:

1. The trifecta of changes to the standard deduction, personal exemption, and child tax credit will simplify the federal tax code significantly, by leading more households to take the standard deduction, rather than itemizing. As such, they will also implicitly reduce the size of tax preferences that favor certain economic activities over others, such as the mortgage interest deduction.[55] Altogether, these three changes are roughly revenue neutral and slightly progressive, so an effort to make them permanent could potentially garner bipartisan support.

2. The new limits on the state and local tax deduction and the mortgage interest deduction are an ambitious attempt by lawmakers to broaden the federal tax base. These provisions will probably need to be extended if lawmakers hope to offset the cost of continuing the other tax cuts in TCJA. Because the underlying policy justifications for the state and local tax deduction and the mortgage interest deduction are relatively weak, efforts to make the new caps into permanent policy would be a positive development.[56]

3. It is likely that the new pass-through deduction will be prove to be prone to abuse – especially given that the majority of business owners will not be subject to any guardrails to prevent them from using the deduction to facilitate tax avoidance.[57] Furthermore, proponents of the provision have still not offered a clear justification of why income from pass-through businesses should be taxed at lower rates than income from wages and salaries. As such, lawmakers should be wary of making the new deduction for pass-through business income into permanent law, in its current form.

55 See, for example, Tax Policy Center, “T18-0008 - Impact on the Tax Benefit of Home Mortgage Interest Deduction (MID) of H.R.1, The Tax Cuts and Jobs Act, By Expanded Cash Income Percentile, 2018,” January 11, 2018.

56 See Jared Walczak, “The State and Local Tax Deduction: A Primer,” Tax Foundation, March 15, 2017; Alan Cole, “A Partial Defense of the Mortgage Interest Deduction,” Tax Foundation, August 20, 2013.

57 The guardrails under section 199A only apply to households if they make more than $157,500 in taxable income ($315,000 if married filing jointly).

Broader Opportunities for Future Tax Reform

Even when lawmakers resolve the status of all of the tax changes scheduled to occur over the next eight years, the work of improving the federal tax code will not be finished. After all, the Tax Cuts and Jobs Act did not address every area of the federal tax code in need of reform. There remain a number of other opportunities to make the federal tax code simpler, more neutral, and more efficient going forward. This section contains a brief description of three of the most promising avenues for reform going forward.

Limiting and eliminating tax expenditures

The federal income tax code still contains over 100 “tax expenditures,” provisions that offer preferential tax treatment to specific economic activities or groups of taxpayers, leading to reduced federal revenue.[58] One key feature of TCJA was that it scaled back the tax benefit from many tax expenditures – both through the creation of new limits on specific provisions, as well as by lowering marginal rates to implicitly reduce the tax benefit from most tax expenditures.

However, TCJA only repealed one major tax expenditure outright, the section 199 domestic production deduction.[59] As a result, many significant tax expenditures still remain in the federal tax code. These include the exclusion of employer-sponsored health insurance, which exempts health benefits provided to employees from income and payroll taxes, reducing federal revenue by hundreds of billions of dollars every year.

As a consequence, there remain many more opportunities for lawmakers to simplify the tax code by eliminating tax expenditures. Future tax reform bills should be ambitious about broadening the tax base by scaling back tax expenditures, and using the resulting revenue to lower marginal tax rates or reduce federal deficits.

Improving cost recovery for structures

One of the most significant distortions remaining in the federal tax code is the rule that businesses that invest in structures (that is, buildings) are required to deduct the cost of these investments over very long periods of time. As mentioned above, TCJA provided 100 percent expensing for short-life assets, such as equipment and machinery. However, the final bill did not significantly improve the ability of businesses to deduct their investments in long-life assets, such as structures.[60]

58 Department of the Treasury, “Tax Expenditures.” It is important to note that many of the provisions on the Treasury’s tax expenditure list should not be characterized as tax expenditures, but should instead be understood as structural attempts to shift the federal tax base to a different paradigm (such as the deferral of foreign source income, the lower rate on capital gains and dividends, and accelerated depreciation). See discussion in Alan Cole, “Corporate and Individual Tax Expenditures 2016,” Tax Foundation, August 1, 2016.

59 See Jim Tankersley, “File Your Taxes on a Postcard? A G.O.P. Promise Marked Undeliverable,” *The New York Times*, December 16, 2017.

60 The bill did reduce the Alternative Depreciation System (ADS) life of residential structures from 40 to 30 years (P.L. 115-97, §13204), although only a small minority of business investment had previously been subject to ADS. Indeed, for businesses that used to depreciate their structures under the Modified Accelerated Cost Recovery System (MACRS) and will now switch to ADS in order to elect out of the new interest deduction limitation, this tax change will *lengthen* asset lives for structures.

As a result, when a company purchases a building, it is still generally required to deduct the cost over 27.5 years (for residential buildings) or 39 years (for nonresidential buildings).[61] Because businesses value deductions in the present more than deductions in the future, there is reason to believe that this feature of the tax code is a significant deterrent to new investment in structures.[62] Making it harder for companies to build factories, office buildings, and apartments in the U.S. has obvious negative economic effects.

There are a number of ways that lawmakers could increase cost recovery for structures in the future, in order to lessen the bias against investing in buildings.[63] Lawmakers could shorten depreciation schedules for residential and nonresidential buildings, or even allow businesses to immediately deduct part or all of the cost of structures. Another option would be to implement "depreciation indexing" (sometimes known as "neutral cost recovery"), which would allow businesses to increase their depreciation deductions by a factor reflecting inflation and the time value of money.

Reforming the taxation of household saving

Another area of the federal tax code that remains ripe for reform is the taxation of household saving. Currently, there are almost a dozen tax-advantaged savings accounts, including traditional and Roth IRAs, 401(k)s, HSAs, and 529s – each with different rules and restrictions. Needless to say, this is an extremely complicated and confusing system, which is a prime target for simplification.

From an economic standpoint, there are additional issues with the taxation of household saving. Arguably, the ideal system for taxing personal saving is one in which households are allowed to deduct the amount they save, and are taxed on the full amount they withdraw, at ordinary income rates (this is the current tax treatment of traditional IRAs and 401(k)s).[64] This ensures that the tax code is neutral between present consumption and future consumption, by taxing a household once when its consumption occurs.

However, the federal tax code does not generally adhere to this ideal. When a household does not make use of a tax-advantaged account, its saving is subject to at two layers of tax: once on the amount saved (when initially earned), and a second on the returns to saving (at rates up to 23.8 percent). In addition, the corporate income tax and the estate tax can function as additional layers of taxation on saving. This system has the effect of burdening the normal return to saving, punishing households that choose to consume in the future rather than the present.

61 26 U.S.C. §168(c)

62 It is worth mentioning that several other features of the new tax bill provide preferential tax treatment for real estate businesses, which may counterbalance some of the negative effects of requiring businesses to deduct the cost of structures over long periods of time. For instance, real estate businesses are allowed to elect to be exempted from the new interest deductibility limit, and are allowed to continue excluding capital gains from like-kind exchanges. On balance, though, it would be better if real estate companies did not receive these tax benefits, and were instead simply afforded greater cost recovery for their investments in structures.

63 These options are outlined in greater detail in Scott Greenberg, "Options for Improving Cost Recovery for Structures," Tax Foundation, October 11, 2017.

64 See Alan Cole, "The Four Different Ways the Tax Code Treats Saving and Investment," Tax Foundation, May 24, 2016.

At the same time, the current tax code also sometimes has the effect of imposing too low of a rate on supernormal returns to saving (such as very lucky investment returns, monopoly rents, and labor income disguised as capital gains). In part, this is due to the use of Roth IRAs and Roth 401(k)s, as well as the step-up in basis at death.

Future tax reform efforts should focus on making the individual income tax code less burdensome on saving, leveling the playing field between present consumption and future consumption, and ensuring that all supernormal returns are subject to tax. This could be achieved through allowing universal tax-deferred savings accounts, eliminating the estate tax, and switching to carry-over basis on inherited assets.

Conclusion

It is often remarked that tax reform is a "once in a generation opportunity," or that tax reform only happens "once every thirty years."[65] However, there is no reason why this needs to be the case. As long as the federal tax code remains complex, inefficient, and preferential toward specific activities, lawmakers should feel emboldened to pass tax reform bills as often as they like.[66]

For now, Congress's top priority on tax policy should be resolving the status of the many tax provisions that are scheduled to change and expire over the next eight years, in order to reduce uncertainty for taxpayers. But as part of that process, lawmakers should also think more broadly about what the federal tax code should look like in the future.

There is more work to be done on improving the federal tax code. The Tax Cuts and Jobs Act should not be the end of the conversation about tax reform, but the beginning of it.

65 See, for instance, Elizabeth Meyer, "Grassley calls tax reform a 'once in a generation' opportunity," *The Hawk Eye* (Burlington, Iowa), November 30, 2017; Olivia Butler, "5 things you need to know about the GOP tax bill that just passed," *TV One*, December 21, 2017.

66 This is hyperbolic, of course – Congress should not pass tax reform bills so frequently that taxpayers lose confidence in their ability to predict what the tax code will look like in the medium term. However, in our current political climate, it seems very unlikely that Congress would ever reach that point.