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Budget Model

The Effects of Growing Federal Debt on the United States' Economy

Differential Tax Rates Create Opportunities for Tax Avoidance

Summary: On June 7, Hill staffers, fiscal experts, and PWBM gathered to discuss the federal revenue loss created by tax avoidance. The U.S. has different tax rates for different income streams, thus there are opportunities for individuals and businesses to reduce their tax bills by recharacterizing income to pay a lower rate.

On June 7, Hill staffers, fiscal experts, and PWBM gathered to discuss the federal revenue loss created by tax avoidance. Speakers examined the means and impacts of individuals and businesses that reduce or avoid their tax bills by recharacterizing their income.

First, PWBM Senior Economist Hill staffers, fiscal experts, and PWBM gathered to discuss talked about the different types of revenue estimates that PWBM produces. Mechanical estimates, also known as "wicked" static, include no behavioral response to policy change; the base of tax thus remains unchanged. "Conventional" estimates, which are sometimes inaccurately referred to as static, include behavior responses to a change in policy; the base of tax thus can change. Conventional estimates do not include macroeconomic feedback effects on, for example, GDP.

Prisinzano then described how PWBM's conventional estimates account for how people and businesses can shift income across time, between business types and between capital and labor income to optimize their tax bills. PWBM's conventional revenue estimates of policies that change tax rates and that account for this tax avoidance behavior are often lower than mechanical estimates.

Eric Zwick, associate professor of finance at the University of Chicago, talked about pass-through business income, which is taxed at individual rates. Zwick suggested that pass-through business income has become a major source of income for the richest Americans. Zwick concluded that many businesses file their taxes as an S Corporation in order to pay less in taxes. S corporation industries tend to be skill-intensive (e.g., doctors, automobile dealers and dentists). On the other hand, partnership corporations tend to occur in more concentrated in law and finance. When businesses switch from C incorporation to S incorporation they also tend to shift towards producing capital income rather than labor income.

Next, Prisinzano showed that after Tax Cuts and Jobs Act (TCJA) of 2017, high-income people with service businesses who cannot access the new 20 percent pass-through deduction will be better off "checking the box" and becoming a C corporation. As a C corporation people can retain their earnings and delay paying tax on those earnings, potentially, forever. About 77 percent of the people who would be better off switching to a C corporation has more than $500,000 in annual income. However, he acknowledged that not everyone optimized their tax bill before the TCJA. Thus, PWBM's estimates account for the fact that not everyone will optimize their tax bill after the TCJA.

The third speaker Michael Knoll, Professor of Law at the University of Pennsylvania, believes that barriers prevent many people from optimizing their taxes. For example, while it is easy to "check the box" and switch from a pass-through business to a C corporation, it is difficult to switch from a C corporation to a pass-through business. Thus, since people face uncertainty about future tax policy, the decision to switch to a C corporation carries some risk. Therefore, people with pass-through business income may hold on to the option to switch to a C corporation.

Lastly, David Kamin, a Professor of Law at New York University, explained how the TCJA increased opportunities to avoid the top individual tax rate using either pass-through businesses or C corporations. Kamin estimates that if top ordinary individual tax rate increases by 10 percent, the government will lose 35 percent of the potential tax revenue because of tax avoidance behavior. He notes that households with higher incomes have the largest incentive to take advantage of tax avoidance strategies. The top individual income tax rate is 37 percent; some individual income from pass-through businesses are eligible for a 20 percent deduction; and the corporate tax rate is lower at 20 percent. Taxpayers will seek out opportunities to pay the least amount of tax.

The panelists discussed why some households and businesses do not engage in tax avoidance, even though they would benefit from it. However, they concluded that as long as the U.S. has different tax rates for different income streams, there will be opportunities and incentives to avoid paying taxes by recharacterizing income to pay a lower rate.