

Key Points

- The “Big 6” recently released a ‘Unified Framework’ for addressing tax reform.
- The details of many key pieces remain unspecified.
- How the details are filled in has differential impacts on the federal budget and economy.

Options for the Unified Framework Tax Plan

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OVERVIEW OF THE UNIFIED FRAMEWORK

The [Unified Framework](#) for tax reform released on September 27, 2017 proposes changes to the current tax code. The plan offers changes to individual, corporate and international taxes. The proposed changes are presented in Table 1. The broad goals include tax relief for middle-class families, simplification and tax relief for businesses. The plan also aims to provide greater fairness by eliminating certain tax breaks. The expectation is that the changes will also remove the incentive for businesses to move jobs and capital overseas.

Table 1: Tax Provisions in the Unified Framework

Tax Provision	Unified Framework
Individual Taxes	
Individual rate, Alternative Minimum Tax (AMT)	12%, 25%, 35%, No AMT
Individual tax rate bracket thresholds	TBD
Standard deduction & personal exemptions	Standard deduction of \$12,000 single, \$24,000 married. Personal exemptions repealed.
Additional Top Rate	TBD
Measure of inflation	TBD
Itemized Deductions	Repealed other than for mortgage interest expense and charitable contributions
Child Tax Credit (CTC)	Increase CTC and keep first \$1,000 refundable as under current policy, increase income limits for phase out and a new \$500 credit for non-child dependents
Repeal of some deductions and credits from individual income while retaining tax benefits that encourage work, higher education and retirement security	Not specified
Business Taxes	
Corporate rate and Alternative Minimum Tax (AMT)	20%, No AMT
Immediate expensing and net interest deduction	Allowed for at least 5 years and partially limited
Repeal business tax expenditures	Low-income housing credit and Research & Development remain
Modernize the tax treatment of certain industries and sectors	TBD
Reduce the double taxation of corporate earnings	TBD
Other Taxes	
Pass-through rate	25%
Prevent conversion of wage income to business income by wealthy individuals as a result of new pass-through rate	TBD
Target the new pass-through rate to small and family-owned businesses	TBD
Repeal the estate tax and generation skipping transfer tax	Yes
International Taxes	
One-time repatriation rate	TBD

Tax Provision	Unified Framework
Territorial tax system	Yes
Taxing the foreign profits of U.S. multinational corporations at a reduced rate and rules to level the playing field between U.S.-based and foreign-based parent companies	TBD

For the individual income tax code, the Unified Framework changes the rate structure from seven brackets into three brackets--12%, 25% and 35%--along with an additional bracket for high income. This new bracket structure is coupled with a number of changes to deductions. The standard deduction is raised from \$6,500 to \$12,000 for individual filers and from \$13,000 to \$24,000 for married filers. The Child Tax Credit (CTC) is raised. Most itemized deductions are erased except for the Home Mortgage Interest Deduction (MID) and the Charitable Contributions Deduction (CCD). Benefits that encourage work, education and retirement are retained. Finally, the Unified Framework also repeals the Alternative Minimum Tax (AMT) and both the Estate and Generation Skipping Transfer Tax.

On the corporate income side, the Unified Framework changes the rate structure from seven brackets into just one: 20%. The corporate AMT is repealed. Immediate expensing is allowed on the cost of new investment in certain depreciable assets for five years while there is a partial limitation on the deduction for net interest expense. The domestic production deduction is repealed. Various other special exclusions and deductions are repealed or restricted. Notable exceptions are the credits for research and development and low-income housing, which are exempt from repeal and restrictions.

The Unified Framework also sets the tax rate faced by small family-owned sole proprietorships, S-Corporations and partnerships (pass-through businesses) at 25%. Under current policy, income from these types of entities are subject to either individual or corporate income tax rates. On the international side, the Unified Framework outlines a move toward a territorial tax system. U.S. companies will face no tax on dividends received from a foreign company in which it owns at least a 10% share. Foreign profits of U.S. multinational corporations will also face a reduced tax rate.

UNSPECIFIED DETAILS IN UNIFIED FRAMEWORK

As Table 1 shows, the Unified Framework leaves the details for many tax policies yet to be resolved.

On the individual side, while the Unified Framework includes a restructuring of tax rate brackets, it does not specify the corresponding income thresholds for the brackets. These thresholds are necessary for determining the change in tax revenue from ordinary income. They are also necessary to determine the amount of capital gain and dividend income that is subject to preferential rates. Subsequently, these thresholds are necessary to determine the change in tax revenue from these income types. The Unified Framework does not provide the details for the additional tax rate on high income earners or specify how to expand the CTC. It also does not identify the work, education and retirement tax preferences that will remain after the changes to the tax code.

On the corporate side, similar issues are present. While all corporate income will be taxed at 25%, it is unclear how the deduction for net interest will be limited. It is also unclear what rate foreign profits will face. Furthermore, it is not clear which special exclusions and deductions will be repealed or limited.

For small businesses, the rate faced by pass-through businesses is also not specified. The Unified Framework specifies that small and family-owned businesses will be taxed at a special tax rate of 25%. However, the Unified Framework does not specify the qualifications to be classified as small or family-owned. It also does not specify

how the special tax rate is applied to income from these businesses. The rate could be applied on all income from these businesses or as a maximum rate on the income, where very small business owners pay an even lower individual tax rate.

THE CHOICES OF FILLING IN THE DETAILS MATTER FOR ECONOMIC GROWTH

Since the Unified Framework has missing pieces, it is not possible to provide a static or dynamic score. However, as policymakers work to fill in the details, it is important that they understand the costs associated with different choices and how they impact the economy.

Table 2 presents three different options for filling in the details: Options A, B and C. Option A is the most costly in terms of lost revenue and adds the most to the debt. As a result, GDP and labor income grow the least of the three options. Option B produces less debt and, consequently, produces more labor income and more GDP growth than option A. Options A and B do not change the Unified Framework's explicit parameters but only fill in missing details in different ways. However, both options increase federal debt over 10 years by more than \$1.5 trillion, inconsistent with the budget recently approved by both the House and Senate. As a result, Option C makes some additional changes to the Unified Framework itself to achieve the \$1.5 trillion target.

Table 2: Tax Provision Options Within the Unified Framework

Option (Modifications to Unified Framework in Italics)

Tax Provision	A	B	C
Individual Taxes			
Individual rate and Alternative Minimum Tax (AMT)	12%, 25%, 35%, No AMT	12%, 25%, 35%, No AMT	12%, 25%, 35%, No AMT
Individual tax rate bracket thresholds	(a)	(a)	(a)
Standard deduction & personal exemptions	Standard deduction of \$12,000 single, \$24,000 married. Personal exemptions repealed.	Standard deduction of \$12,000 single, \$24,000 married. Personal exemptions repealed.	Standard deduction of \$12,000 single, \$24,000 married. Personal exemptions repealed.
Additional Top Rate	No	No	<i>39.6% on income over \$1M</i>
Measure of inflation	Current Law	Current Law	<i>Chained CPI-U</i>
Itemized Deductions	Current Law	<i>Repeal State and Local</i>	<i>Repealed other than mortgage interest expense and charitable contributions</i>
Child Tax Credit (CTC)	A new \$500 credit for non-child dependents.	<i>Increase CTC to \$1,500 and keep first \$1,000 refundable as under current policy, increase income limits for phase out by 50% and a new \$500 credit for non-child dependents. (b)</i>	<i>Increase CTC to \$1,500 and keep first \$1,000 refundable as under current policy, increase income limits for phase out by 50% and a new \$500 credit for non-child dependents. (b)</i>
Tax treatment of carried interest	Current Law	Current Law	<i>As ordinary income</i>
Business Taxes			
Corporate rate and Alternative Minimum Tax (AMT)	20%, No AMT	20%, No AMT	<i>25%, No AMT</i>
Expensing of Investment	Immediate expensing	Immediate expensing	Immediate expensing
Other Taxes			
Pass-through rate	25%	25%	<i>28%</i>
International Taxes			

Option (Modifications to Unified Framework in Italics)

Tax Provision	A	B	C
One-time repatriation rate	No	<i>8.75% on cash, 3.5% on non-cash, paid over 10 years</i>	<i>12% on cash, 3.5% on non-cash, paid over 10 years</i>

(a) See text.

(b) In 2018, under current policy, the amount of the credit is reduced by 5 percent of income above \$75,000 for single filers and above \$110,000 for married couples filing jointly. Under the policy to increase income limits for phase out by 50%, the amount of the credit is reduced by 5% of income above \$112,500 for single filers and above \$165,000 for married couples filing jointly.

Note: Many provisions that are consistent with the Unified Framework are not presented above. Those provisions include the repeal some deductions and credits from individual income while retaining tax benefits that encourage work, higher education and retirement security, repeal the estate tax and the generation skipping transfer tax, measures to prevent the conversion of wage income to business income by wealthy individuals as a result of the new pass-through rate, target the new pass-through rate to small and family-owned businesses, methods to reduce the double taxation of corporate earnings, modernizing the tax treatment of certain industries and sectors, the shift to a territorial system, taxing the foreign profits of U.S. multinational corporations at a reduced rate, and rules to level the playing field between U.S.-based parent companies and foreign-based parent companies.

Option A

On the individual side, as noted above, individual rate bracket thresholds are currently unspecified in the Unified Framework. In Option A, we consider the following structure: income below \$38,700 (\$77,400) for single (married) filers faces the 12% rate; income above \$38,700 (\$77,400) but below \$426,700 (\$480,050) faces the 25% rate; and income above \$426,700 (\$480,050) faces the top rate of 35%. This rate structure--along with increasing the standard deduction to \$12,000 for singles (\$24,000 for married) and repealing the personal exemptions--either holds constant or reduces the rate faced at all income levels. Furthermore, the individual AMT is repealed while all itemized deductions are left intact. This option also adds a new \$500 credit for non-child dependents.

Corporations face the 20% tax rate, although no AMT. This change decreases or holds constant the rate faced by all corporations except for those with less than \$50,000 of income, which face an increase from 15% to 25%. In addition, investment in non-structure depreciable assets can be immediately and fully expensed. The Unified Framework also suggests a limitation on net interest expense but provides no details. As such, Option A uses current law treatment of net interest.

Income from pass-through businesses is concentrated among high-income earners who would face the top marginal rate of 35%. A special pass-through rate of 25% is a reduction in the rate faced by this income. The Unified Framework also suggests that measures that stop the conversion of wage income to pass-through income will be implemented. It is not clear what the measures will be and they are not considered in this analysis. Option A does not consider any restrictions on the types of businesses that could take advantage of the special rate. Either type of restriction will reduce the cost of the rate change.

Option B

Option B modifies option A in three specific ways. First, it repeals the State and Local Tax Deduction (SALT). Second, it increases the CTC to \$1,500 (from \$1,000) while increasing the income limits by 50%. Third, it implements one-time repatriation rate for cash (8.75%) and non-cash (3.5%) payable over 10 years.

Option C

Option C further modifies option B in a number of ways. First, it adds an income bracket for income over \$1 million (39.6%). Second, it repeals all itemized deductions other than the MID and the CCD. Third, it taxes carried interest as ordinary income. Fourth, it adjusts the one-time repatriation rates for cash (12%). Finally, it modifies the Unified Framework itself by taxing corporate income at 25% (instead of 20%) and pass-through income at 28% (instead of 25%).

COMPARISON OF OPTIONS

Figure 1 presents the static (solid lines) and dynamic (dashed lines) revenue effects from 2017-2040 for each of the options. The dynamic effects are typically less costly than their static counterparts due to the reduction in capital taxes in each of the options. Figure 2 shows GDP under the three options, while Figures 3 and 4 show debt and labor income, respectively. For the dynamic effects, the economy is assumed to be 40% open and 60% closed, consistent with the [empirical evidence](#) about the 40% marginal take up of Treasury bonds by foreigners. Moreover, as discussed more below, the rate of return on capital is equal to the marginal product of capital net of depreciation, which generally creates an optimistic case for dynamic effects.

Figure 1: Federal Tax Revenues

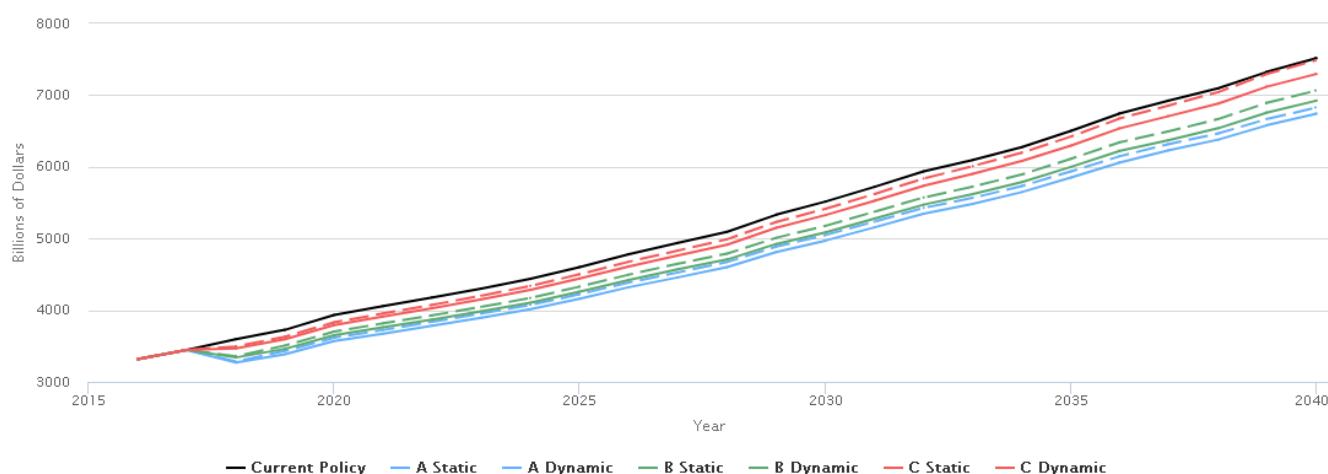


Figure 2: U.S. Gross Domestic Product (GDP)

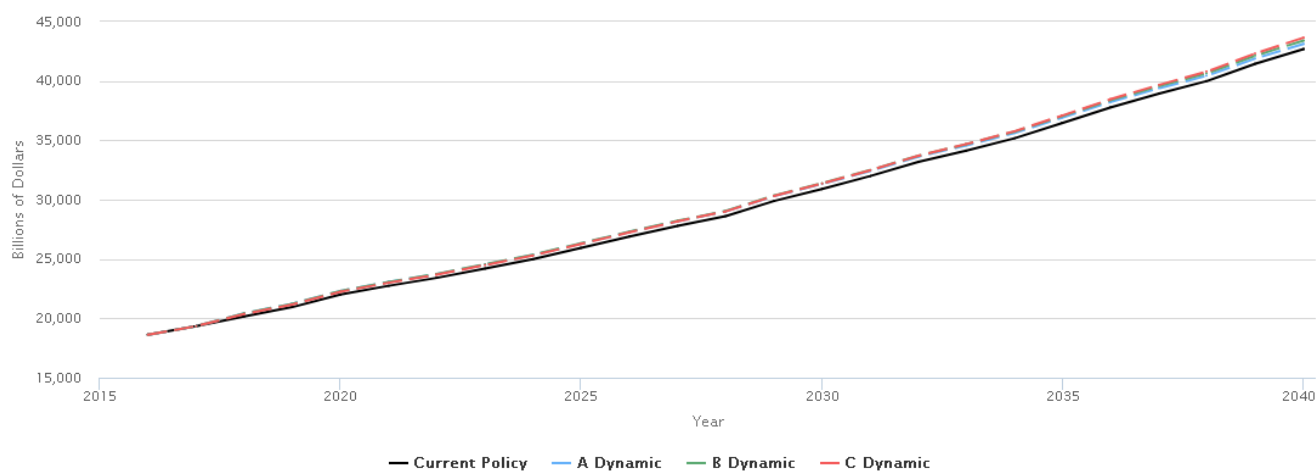


Figure 3: Federal Debt

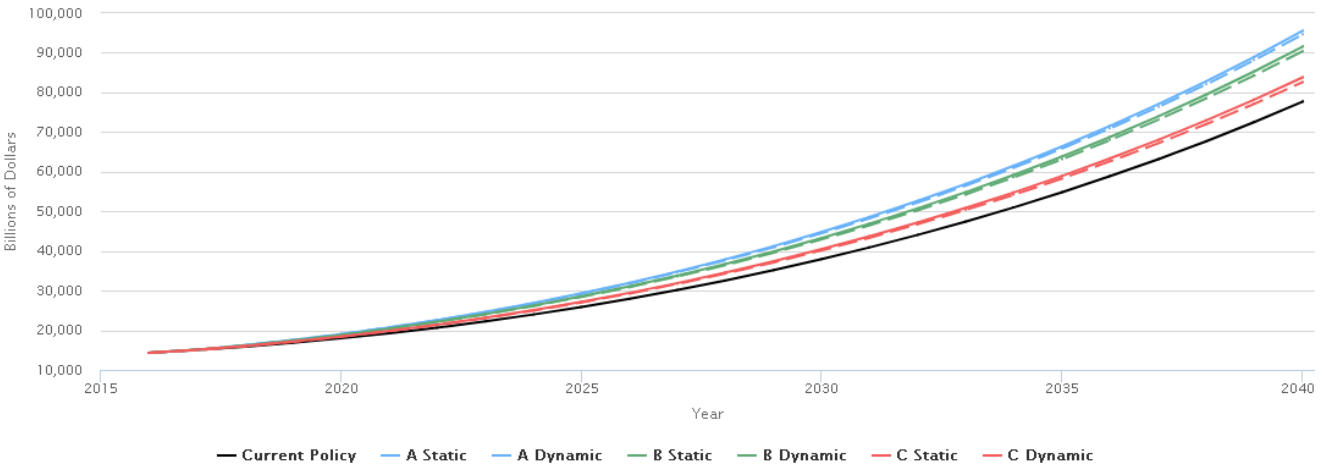
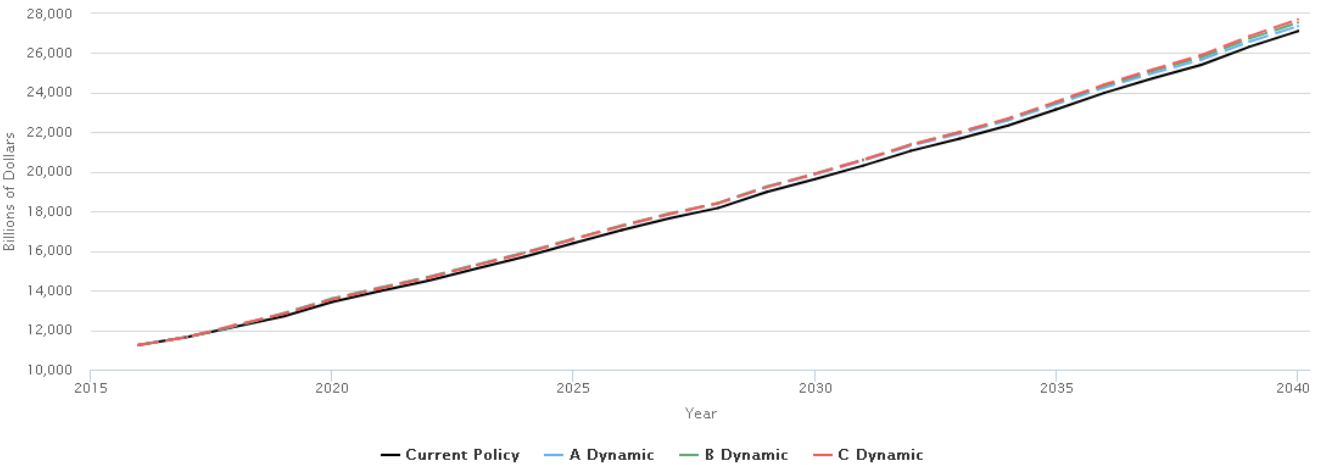


Figure 4: U.S. Labor Income



Revenue

Figure 1 shows the effect on federal tax revenue of three tax provisions options within the Unified Framework. Option A loses \$4 trillion in federal tax revenue over the next 10-years (solid blue line) on a static basis. Corporate revenue is reduced by \$2.3 trillion while the individual liability is reduced by \$1.7 trillion. The dynamic estimate for the total revenue losses is slightly smaller at \$3.5 trillion (dashed blue line). Over the next 22 years (until 2040), Option A loses \$12.2 trillion on a static basis. Corporate revenue is reduced by \$6.8 trillion while individual revenue is reduced by the remaining \$5.5 trillion. On a dynamic basis, this option loses less revenue, about \$10.6 trillion over the next 22 years.

Option B (green lines) losses \$3.1 trillion over the next 10-years on a static basis. Corporate revenue losses are the same as Option A, at \$2.3 trillion. However, the individual liability is reduced by \$794 billion. The dynamic estimate for the total revenue loss is smaller at \$2.6 trillion (dashed green line). Over the next 22 years, this option loses \$9.5 trillion on a static basis. Corporate revenue is reduced by \$6.8 trillion while individual revenue is reduced by \$2.8 trillion. On a dynamic basis, Option B loses \$7.5 trillion over the next 22 years, about \$2.0 trillion less than the static score.

Option C (red lines) loses only \$1.5 trillion over the next 10-years on a static basis. Corporate revenue losses are \$1.6 trillion while the individual liability increases slightly. The dynamic estimate for the total revenue losses is smaller at \$1.0 trillion. Over the next 22 years, this option loses \$4.1 trillion on a static basis, due to \$4.5 trillion

from lost corporate revenue and an increase in \$400 billion from individual revenue. On a dynamic basis, this option loses \$2.0 trillion over the next 22 years, almost half of the static estimate.

Labor Income

Option A not only decreases tax revenues by the most of the three options, it increases labor income the least in the long run. After 10 years (at 2027), labor income is 1.3% higher than under current law. After 22 years (at 2040), labor income is only .9% higher than under current law, largely due to rising debt that mitigates wage increases. Under Option B, labor income is 1.4% higher after 10 years than current law. After 22 years, labor income is 1.6% higher than under current law. For Option C, labor income is 1.3% higher in 10 years than under current law. After 22 years, labor income is 2.2% higher than under current law. The effects on labor income are presented in Figure 4.

GDP

As in the other statistics presented, Figure 2 shows that Option A has the smallest impact on GDP. After 10 years, GDP is 1.4% higher than under current law. After 22 years, GDP is only 1.0% higher than under current law. Under Option B, GDP is 1.5% higher in 10 years relative to current law. After 22 years, GDP is 1.7% higher than under current law. For Option C, GDP is 1.3% higher than under current law, slightly less than Option B. After 22 years, GDP is 2.3% higher than under current law, a bit more than Option B. Relative to Option B, Option C does less to stimulate the economy the short run but also accumulates less debt over time.

SENSITIVITY ANALYSIS OF THE DYNAMIC ANALYSIS OF OPTION C: A LOWER RETURN

Penn Wharton Budget Model's [Tax Policy Simulator](#) allows for two different assumptions on the rate of return on capital: (a) "high" return where the return is assumed to be the marginal product of capital net of depreciation, (b) "low" return where the return is assumed to be close to the risk-free rate. For the results discussed above, we assume a "high" rate of return, which produces macroeconomic results that are generally more favorable for tax cuts. However, the "low" return assumption is generally more consistent with existing tax law that allows for tax loss offsets, which means that the tax on the "equity premium" portion of the marginal product of capital is effectively risk shared with the government.¹ We now consider the dynamic effects associated with a lower return.

Revenue

Now consider Option C (with 40% open international capital flows) with a low rate of return on capital, close to the risk-free rate. Over 10 years, the dynamic tax revenue loss is \$1.3 trillion, compared to \$1.0 trillion under the high rate of return assumption (but still less than the static loss of \$1.5 trillion). Over 22 years, the dynamic tax revenue loss is \$3.1 trillion, compared to \$2.0 trillion with the high rate of return assumption.

Labor Income

At the 10 year mark, labor income is 0.68% higher than under current law. This change is about 40% less relative to the high rate of return assumption. At the 22 year mark, labor income is 1.15% higher than current law, or about 45% less than the change under the high rate of return assumption.

GDP

GDP is 0.76% higher than current law at the 10 year mark, almost half of the change under the high rate of return assumption. At the 22 year mark, GDP is 1.2% higher than under current law, about half of the increase predicted under the high rate of return assumption.

Conclusion

The Unified Framework presented an outline for tax reform. Many of the details were left ambiguous. In order to make decisions on the details, it is important to understand the short- and long-term effects of those decisions. This brief presented three sets of possible options, ranging from high cost (Option A) to lower cost (Option C). Option C fits within the recently passed budget that allows for a \$1.5 trillion deficit. Certainly, there are many other options to consider. Lawmakers and users are encouraged to explore using PWBM's [Tax Policy Simulator](#) in more detail.

[Updated on 11/1/2017: Updated the characterization of tax provisions.]

1. Current law tax loss offsets are only approximate risk sharing in the corporate world because loss offsets can't be carried forward at the government bond rate. Toward that end, the House GOP 2016's "A Better Way" plan recommended allowing loss offsets to be carried forward with interest. When real interest rates are low, the current loss offset system is close to full risk sharing for corporate income under existing international tax rules. Loss offsets, however, are very far from perfect risk sharing for entrepreneurs who risk personal resources, and who might never be able to recapture those losses against future gains. Instead, current IRS law allows for 83(b) election to indirectly reward entrepreneurs with capital gains treatment on their restricted stock purchased at par. [↩](#)