The Daily Dish

Mnuchin on Tax Reform

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Eakinomics: Mnuchin on Tax Reform

At its core, tax reform means broadening the base and lowering rates so taxes have less influence on business decisions. So it was particularly startling for Treasury Secretary Mnuchin to give a speech on tax reform and have the Wall Street Journal report that "At the National Federation of Independent Business, the influential trade group for small businesses and pass-throughs, 'everybody's eyes kind of popped out' when they heard Mr. Mnuchin's comments, said Brad Close, senior vice president for advocacy. 'We just think that's bad government policy, for sure,' he said. 'It picks winners and losers based on industry type and we just think that's a terrible way to go for tax reform.'"

What is going on? Over 50 percent of business income is taxed on individual income tax returns via so-called "pass-through" entities like partnerships, sole-proprietorships, and so forth. Accordingly, the taxation of wages, salaries, dividends, and business income is governed by the same rate schedule. Some tax reforms seek to reduce the corporate tax rate and, for rough parity, cut taxes on pass-through business income as well. In order to do so without cutting the top rate on the "rich," a new and lower rate is created for business income. This is exactly the idea that Secretary Mnuchin floated. This is fine at first blush, but creates a real tax avoidance opportunity.

I am paid a salary by AAF and it is subject to regular income tax rates. Suppose Congress introduces a business income tax rate of, say, 15 percent —much lower than my current tax rate. I could start a sole-proprietorship called DHE Management (DHE) and have DHE sign a contract for my services with AAF at exactly the same amount as my salary. AAF has the same services and the same costs. But, voila, my salary has been transformed into business income and my tax rate cut.

This is unattractive, but there is really no easy fix. "If you're an accountant firm and that's clearly income, you'll be taxed an income rate, you won't be taxed a pass-through rate," Secretary Mnuchin said. "If you're a business that's creating manufacturing jobs, you're going to get the benefit of that rate because that's going to be passed through to help create jobs and better wages." This <u>is</u> picking manufacturing over accounting, and generated the NFIB's response. It also runs into problems because you could work at an accounting firm and simultaneously have an accounting business (helping manufacturers) on the side. Now you'd have legitimate business income treated as wages and salaries.

An alternative is to simply have a rule that says a certain fraction of your pass-through income will be treated as wages and salary. It's not right either, but it guarantees that in my example I pay the higher tax on some of my income.

Or, one can simply keep with the current system and lower the top tax rate on all income. This guarantees equal treatment of all pass-through businesses, but lowers tax rates on all sources of income.

The Mnuchin episode is a reminder of why tax reform is so hard — there is often conflict among sensible objectives. It is also a reminder that it is usually better to go public with the whole plan that contains all the good news and all the bad news, rather than allow each provision to be litigated in isolation from the overall merits of tax reform.