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Four Priorities for Tax Reform 2.0—and Seven Supporting Reforms

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The Tax Cuts and Jobs Act (TCJA) simplified tax paying for most Americans, cut taxes for individuals and businesses, and updated the tax code so that American businesses and the people they employ can again be globally competitive. Much of the TCJA's reforms, however, are temporary and require additional congressional attention. Priorities for the next round of tax changes should focus on finishing reforms that began in 2017 and further simplify the tax code to allow Americans to save and invest for their future.

Permanence Is Key

The TCJA reduced federal income tax rates, increased the standard deduction, doubled the child tax credit, repealed the personal and dependent exemptions, and capped the deduction for state and local taxes. Procedural rules in the Senate and an unwillingness to constrain spending forced Congress to make the majority of the TCJA temporary. The law expires in large part in 2025 and Americans' taxes are scheduled to increase in 2026.

The first priority for Congress is to make the already agreed-upon provisions permanent. In addition to protecting Americans' paychecks from higher taxes, a permanent version of the TCJA could increase the size of the economy by 2.8 percent over the pre-TCJA baseline. That is a full percentage point more—or thousands of dollars of additional income per American household—than what is expected to result from the temporary provisions under current law.[1]

Simply by making the temporary provisions permanent, Congress could achieve an additional 60 percent of the economic benefit of 2017's major tax reform.

Expensing More than Doubles Tax Reform's Increase of GDP

Lower tax rates have received the most attention, but the law's adjustments to investment rules bring equally important benefits for American workers through higher wages and more jobs. The pre-TCJA U.S. tax system made businesses wait to deduct the cost of their investments from their taxable income. This delay between paying for an investment and then deducting the investment increases the cost of the investment itself and shrinks incomes.

The TCJA fixed this problem through "expensing," allowing businesses to write off new investments immediately. However, expensing under current law only applies to certain investments with shorter working lives, such as equipment and machinery. Buildings, such as new manufacturing floor space and storefronts, still have to use the costly and complicated pre-TCJA system. The budgetary cost of full expensing is high in the first few years of the reform on account of transition costs, but the economic benefits of the new system are well worth the short-term budget impact.

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The expansion of expensing to all investments, paired with permanent tax cuts, would increase U.S. gross domestic product (GDP) by 4.3 percent over the pre-reform baseline. That is approximately $4,000 per year in potential income for the average household, compared to the current, expiring law.

Tax Each Dollar Only Once

The current tax code double-taxes many forms of savings and investment. Income that is saved or invested is taxed, and the return on that savings or investment is then taxed again. Moreover, income from investments in most corporations is taxed yet again—first at the corporate level and then at the individual level when dividends are received or capital gains on stock are paid. By double-taxing or triple-taxing saving and investment at high rates, the tax code deters families from saving for retirement, education, or any other purpose.[2]

The continuation of tax reform should include the simplification of retirement accounts and the creation of a new Universal Savings Account.

- **Retirement Accounts.** Most Americans are familiar with personal retirement savings accounts, such as 401(k)s, but few take full advantage of their benefits. The main impediment to more widespread use of the accounts is their complexity. Very few small employers, for example, offer retirement accounts because of high compliance costs and the regulatory risk of maintaining them.[3] The IRS lists more than sixteen different private retirement accounts, each with its own eligibility rules, income and contribution thresholds, early withdrawal penalties, and employer requirements.[4] The patchwork of rules discourages saving and subdivides individual's savings into multiple accounts, often marooned with past employers.

  Retirement savings is one of the most complex areas of tax law and desperately needs simplification. Tax Reform 2.0 should eliminate the multiple sets of rules that govern similar retirement accounts in favor of a more streamlined system.

- **Universal Savings Accounts.** Like the current tax treatment of retirement savings through employer sponsored 401(k) plans or individual retirement accounts (IRAs), income deposited into a universal savings account would only be taxed once—allowing any investment growth to be withdrawn without a tax penalty. Different from retirement savings, these accounts contain no restrictions on disbursements, allowing families to spend their money when it suits them best. Tax Reform 2.0 should create a new Universal Savings Account to supplement retirement savings.

Simplify the Taxation of Education

Tax Reform 2.0 should complete the unfinished reforms proposed in the House Ways and Means Committee report from November 2017. The Committee proposed expanding 529 college savings accounts eligibility and consolidating higher-education tax subsidies.[5]

The TCJA expanded 529 college savings accounts—named after their section of the Internal Revenue Code—to allow parents to also save for K–12 expenses. The original House plan proposed more robust reforms to make 529 college savings accounts eligible for homeschool, career, and technical education expenses, raised the annual limit for plan contributions, and consolidated the similar Coverdell Savings Accounts. These additional reforms would increase the ability of parents to pay for education options outside the public school system, giving families more education choices.

The House plan also proposed consolidating seven existing higher education tax programs into a single

1. Adam N. Michel and Parker Sheppard, "Simple Changes Could Double the Increase in GDP from Tax Reform," Heritage Foundation *Issue Brief* No. 4852, May 14, 2018, https://www.heritage.org/taxes/report/simple-changes-could-double-the-increase-gdp-tax-reform.
2. Erica York, "The Complicated Taxation of America's Retirement Accounts," Tax Foundation *Fiscal Fact* No. 589, May 22, 2018, https://taxfoundation.org/retirement-accounts-taxation/ (accessed July 11, 2018).
3. David Burton, "The Tax Code as a Barrier to Entrepreneurship," testimony before the Committee on Small Business, U.S. House of Representatives, February 15, 2017, https://www.heritage.org/testimony/the-tax-code-barrier-entrepreneurship.
4. Internal Revenue Service, "Types of Retirement Plans," https://www.irs.gov/retirement-plans/plan-sponsor/types-of-retirement-plans (accessed July 11, 2018).
5. Tax Cuts and Jobs Act, Public Law No. 115–97.

expanded and simplified American Opportunity Credit.[6] The proposed reforms would work to better target the benefits to those in need, simplify the system for those who are eligible, and reduce fraud.

Short of eliminating tax subsidies for higher education all together, the House plan provides a sensible road map for Tax Reform 2.0.[7]

Seven Supporting Reforms

Congress should use the next round of tax reform to build on the TCJA's successes by finishing the reforms discussed above and addressing the following seven important supporting reforms.[8]

1. **Repeal the Estate and Gift Tax.** Commonly known as the "death tax," the estate and gift tax should be fully repealed, as it is an additional layer of tax on saving and investment. The TCJA temporarily increased the death tax's standard deduction. Tax Reform 2.0 should repeal the tax completely.[9]

2. **Index Capital Gains to Inflation.** The income tax system is indexed to inflation to protect taxpayers from paying higher taxes on artificially higher wages. Indexing the purchase price of assets for inflation would equally protect savers from taxes on fictitious income.[10]

3. **Remove Tax Subsidies.** The vast majority of tax credits are narrowly targeted subsidies that should be repealed. The Heritage Foundation's 2019 *Blueprint for Balance* recommends repealing 28 tax credits, totaling $735 billion over 10 years.[11]

4. **Repeal the Alternative Minimum Tax (AMT).** The TCJA raised the exemption for this parallel tax system, making it even more obsolete. The AMT should be fully repealed for all taxpayers.

5. **Repeal the State and Local Tax (SALT) Deduction.** The TCJA placed a $10,000 cap on the state and local tax deduction. Tax Reform 2.0 should eliminate all state and local tax deductions for individuals and corporations. The full and permanent elimination of these deductions could allow federal tax rates to decline further and fully eliminate the federal tax subsidy to high-tax states.

6. **Eliminate Tax Impediments to the Use of Alternative Currencies.** Congress should define the term currency (or alternative currency) in the Internal Revenue Code to ensure equal tax treatment among alternative currencies. Congress could implement this method by (1) excluding "alternative currencies" from the definition of capital asset, and (2) excluding gains or losses from the sale or exchange of an alternative currency from gross income. Congress should also simplify the information reporting requirements and eliminate back-up withholding for alternative currency transactions.[12]

7. **Allow S Corporations to Use Equity Crowdfunding.** The tax code makes it almost impossible for millions of small businesses to use equity crowdfunding to raise growth capital. The tax law needs to be amended to eliminate this impediment to small firm capital formation so that shareholders who only acquired their shares via

6. Ryan Ellis, "House Tax Reform Bill Improves Education Policy," *Forbes*, November 14, 2017, https://www.forbes.com/sites/ryanellis/2017/11/14/house-tax-reform-bill-improves-education-policy/#742d95b120c5 (accessed July 11, 2018).
7. Andrew Wilford, "Reforming Higher Ed Tax System Should Be Part of Tax Reform 2.0," National Taxpayers Union Foundation *Issue Brief* No. 178, June 28, 2018, https://www.ntu.org/library/doclib/2018/06/NTUF-IB-179-higher-ed-tax-credits.pdf (accessed July 11, 2018).
8. Adam N. Michel, "Tax Reform 2.0: Priorities After the Tax Cuts and Jobs Act of 2017," Heritage Foundation *Backgrounder* No. 3296, March 22, 2018, https://www.heritage.org/taxes/report/tax-reform-20-priorities-after-the-tax-cuts-and-jobs-act-2017.
9. Ryan Ellis, "Tax Reform 2.0 Must Include Death Tax Repeal," *The Washington Examiner*, June 29, 2018, https://www.washingtonexaminer.com/opinion/tax-reform-2-0-must-include-death-tax-repeal (accessed July 11, 2018).
10. Stephen J. Entin, "Getting 'Real' with Capital Gains Taxes by Adjusting for Inflation," Tax Foundation *Fiscal Fact* No. 577, March 6, 2018, https://taxfoundation.org/inflation-adjusting-capital-gains/ (accessed July 11, 2018).
11. Adam N. Michel, "Reduce Spending Through the Tax Code," *Blueprint for Balance* (Washington, DC: The Heritage Foundation, 2019), https://www.heritage.org/blueprint-balance/blueprint-balance/reduce-spending-through-the-tax-code.
12. David R. Burton and Norbert J. Michel, "Removing Tax Barriers to Competitive Currencies," Heritage Foundation *Issue Brief* No. 4761, September 13, 2017, https://www.heritage.org/sites/default/files/2017-09/IB4761.pdf.

a crowdfunding offering or a Regulation A offering are not counted towards the 100 shareholder S corporation limit.[13]

Spending Reforms Are Key to Tax Reform 2.0

Systemic deficits and growing debt will constrain future tax reform efforts and unnecessarily turn any conversation on tax reform into a debate about how to raise additional revenue, imperiling the successes of the TCJA tax cuts.

The problems of deficit and debt are driven by too much spending, not too little tax collection. Without spending-based reforms, deficits will continue to grow, requiring still higher taxes in the future. Following the 2017 tax cuts, the Congressional Budget Office projects that 2018 federal revenues will be more than $20 billion higher than the previous year.[14] The size of the recent tax cuts are miniscule compared to the ongoing spending increases. Outlays will continue to far exceed revenues until Congress places meaningful constraints on federal spending.

Conclusion

Budget constraints and political considerations will inevitably complicate any congressional efforts in the next round of tax reforms. Congress must first make the TCJA permanent, including the limited expensing included in the 2017 law. After achieving permanence, the priorities above, with the exception of full expensing, do not have large budgetary impacts and some suggestions such as further limiting the SALT deduction would help offset additional reforms.

To solidify the economic and policy successes of the TCJA, Congress should:

- **Make** the TCJA permanent to ensure American's taxes stay low after 2025,
- **Expand** expensing to further boost the economy and help workers earn higher wages,
- **Simplify** retirement savings and allow all taxpayers to save in a universal savings account with greater flexibility, and
- **Streamline** the taxation of education by expanding 529 college savings account eligibility and streamlining federal tax subsidies for higher education.

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13. David Burton, "The Tax Law Makes It Almost Impossible for 'S Corporations' to Use Equity Crowdfunding," *The Daily Signal*, April 19, 2016, https://www.dailysignal.com/2016/04/19/the-tax-law-makes-it-almost-impossible-for-s-corporations-to-use-equity-crowdfunding/.
14. Congressional Budget Office, *The Budget and Economic Outlook: 2018 to 2028*, April 9, 2018, https://www.cbo.gov/publication/53651 (accessed July 11, 2018).