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The Tax Reform Act of 2014

Background and Proposed Changes

Context. On February 26, 2014, House Committee on Ways and Means Chairman Dave Camp introduced the Tax Reform Act of 2014 as a discussion draft. This comprehensive draft builds on earlier discussion drafts released by Chairman Camp, which had addressed international tax, financial products, and small business.

Individual Income Tax. Under the proposal, there would be two regular income tax brackets, with rates of 10% and 25%. A third bracket would apply to an alternative definition of income, making for a top statutory rate of 35%. The 35% bracket results from a 10% tax on modified adjusted gross income (MAGI) above certain income thresholds ($400,000 for single filers; $450,000 for joint filers). The 10% bracket is phased-out for certain higher-income taxpayers. Brackets would be adjusted for inflation using chained-CPI. Dividends and capital gains would be taxed as ordinary income, but 40% of net capital gains and qualified dividends would be excluded from taxable income. The proposal would also repeal the Alternative Minimum Tax (AMT).

Other substantial changes to the structure of the individual income tax system include an elimination of personal exemptions and an increase in the standard deduction. The standard deduction would be set at $22,000 for joint filers, and $11,000 for other individual filers. An additional standard deduction of $5,500 would be available for single filers with at least one child. The standard deduction would be phased-out for certain higher-income taxpayers. A number of tax preferences, including standard and itemized deductions (except charitable contributions), could only be taken against the 25% bracket.

The Tax Reform Act of 2014 would reduce average and effective marginal tax rates for most individual taxpayers.

The proposal would also modify or eliminate a number of individual income tax credits, deductions, and other provisions. Major changes include eliminating the deduction for state and local tax payments; scaling back the mortgage interest deduction and earned income tax credit (EITC); modifying the charitable deduction and education incentives; and making changes in 401(k) and Roth IRA retirement savings vehicles.

Corporate and Business Income Tax. All C corporations would be taxed at a top statutory rate of 25% under the proposal, with the statutory rate reduction phased in through 2019. Other business income, including income earned by S corporations, partnerships, and sole proprietorships, would be taxed through the individual income tax system. The 35% bracket in the individual system would not apply to qualified domestic manufacturing income. Similar to the individual system, the proposal would modify or eliminate a number of corporate and business income tax credits, deductions, and other provisions. Among the changes are elimination of the modified accelerated cost recovery system (MACRS); amortization of research and experimental expenditures and advertising expenses; modification of the net operating loss (NOL) deduction; phased-out repeal of the Section 199 domestic production activities deduction; and repeal of the last-in, first-out (LIFO) method of inventory accounting. The corporate AMT is also repealed.

Taxation of Multinationals. The proposal would make significant changes to the tax treatment of foreign-source income earned by U.S. multinational corporations. Specifically, the proposal would adopt a 95% exemption for dividends received by U.S. corporations from foreign subsidiaries. Subpart F rules would be modified, providing broad taxation of intangible income of foreign subsidiaries when earned, with foreign intangible income subject to a 15% rate (once fully phased in). The proposal also includes "thin capitalization" rules that restrict domestic interest deductions. There would also be a one-time tax on previously untaxed earnings and profits (E&P) of foreign subsidiaries of U.S. corporations. E&P retained as cash would be taxed at 8.75%, while any remaining E&P would be taxed at 3.5%.

Other Changes. Numerous changes were also proposed with respect to tax-exempt entities, administration and compliance, and excise taxes. Among the proposed changes is an excise tax on systemically important financial institutions and repeal of the medical device tax.

Revenue Effects

The Joint Committee on Taxation (JCT) has estimated that the Tax Reform Act of 2014 would increase federal revenues by $3.0 billion over the 2014 to 2023 budget window (see **Table 1**). Overall, revenues collected from individuals would be expected to decrease by about $588.4 billion between 2014 and 2023 (including AMT repeal). Revenues collected from businesses, including multinationals, would be expected to increase by $520.5 billion over the same time frame. The new tax on financial institutions would also raise additional revenues.

Revenue Stability. While the JCT estimates indicate the proposal would be roughly revenue-neutral over the 10-year budget window, the proposal could result in reduced tax revenues in the longer-term. Some of the major revenue-raising provisions are one-time sources, including the tax on deferred foreign income and the changes in rules related to Roth IRA accounts. The proposed changes to depreciation are also likely to raise less revenue over the long-term than in the 10-year budget window. Reduced corporate tax rates are also phased-in gradually, limiting revenue losses in the first 10 years.

Table 1. Estimated Revenue Effects (billions)

Provision	2014 - 2023
Individual Income Tax	
Reduced Individual Rates	-$543.8
Increased Standard Deduction	-$666.2
Increased Child Tax Credit	-$554.0
Modified Earned Income Tax Credit	$217.2
Repeal Personal Exemptions	$987.2
Changes to Itemized Deductions	$858.4
Changes to Roth IRAs	$143.7
Other Individual Items	$301.0
Total Individual	***$743.4***
Alternative Minimum Tax (AMT)	
Repeal Individual AMT	-$1,331.8
Repeal Corporate AMT	-$110.2
Total AMT	***-$1,442.0***
Corporate and Business Income Tax	
Reduced Corporate Rate (phased in)	-$680.3
Reform Depreciation	$269.5
Amortization of Research Expenses	$192.6
Amortization of Advertising Expenses	$169.0
Repeal Section 199 (phased out)	$115.8
Other Business Items	$498.2
Total Business	***$562.4***
Taxation of Multinationals	
Deduction for Foreign Dividends	-$212.0
Tax on Deferred Foreign Income	$170.4
Subpart F Reform	$115.6
Other International Items	-$5.7
Total International	**$68.3**
Excise Tax	
Excise Tax on Financial Institutions	$86.4
Other Excise Tax	-$28.1
Total Excise Tax	**$58.3**
Other (Tax-Exempts and Tax Administration)	
Total Other	**$12.6**
Total	**$3.0**

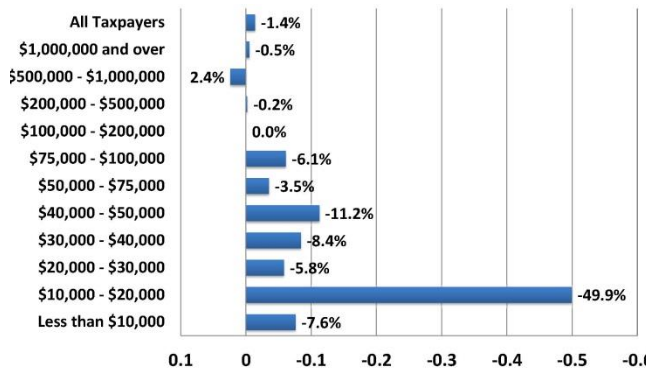
Source: Joint Committee on Taxation, JCX-20-14. Table created by CRS.

Distributional Effects

Change in Tax Burden. According to JCT estimates, once the policies are fully implemented, federal taxes paid would decrease for all except the $500,000 to $1,000,000 income group (see **Figure 1**). By 2023, taxpayers in lower income categories would experience larger percentage decreases in federal taxes.

As the policies are phased-in, JCT estimates that federal taxes would initially increase for those in the lowest and the highest income categories. By 2017, federal taxes would decrease, on average, for all income categories of less than $100,000. In 2017, all income categories of $100,000 or more would experience an increase in federal taxes. It is not until 2023 that the JCT estimates that federal taxes would decrease for the income category of $1,000,000 and above.

Figure 1. Change in Federal Taxes, 2023



Source: Joint Committee on Taxation, JCX-21-14. Figure created by CRS.

A decreased federal tax liability on average within an income category does not necessarily mean that federal taxes would fall for all taxpayers in a given income category. Further, some taxpayers may face increased marginal effective tax rates, given the various surtaxes and phase-outs in the propsoal.

Macroeconomic Analysis

Using a variety of modeling techniques, the JCT's macroeconomic analysis of the base-broadening, rate-reducing tax reform proposal found the following:

- GDP is projected to grow by an additional 0.1% to 1.6% during the 10-year budget period.
- Labor supply, private employment, and consumption are all projected to increase. These effects are driven by reduced effective marginal tax rates on labor and increased after-tax incomes.

Reduced after-tax returns to investment may lead to reduced business investment in capital stock over time.

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