October 2, 2017

The Tax Reform Framework

The proposed tax reform "Unified Framework for Fixing Our Broken Tax Code" was released on September 27, 2017. The Framework, agreed to by the majority party leaders of the House and Senate and the chairmen of the Ways and Means Committee and Senate Finance Committee, along with representatives of the Administration, contains many elements of the House tax reform blueprint, the "Better Way," released in 2016. The "Better Way" blueprint is analyzed in CRS Report R44823, *The "Better Way" House Tax Plan: An Economic Analysis*, by Jane G. Gravelle.

Many of the details of a potential tax reform are not outlined in the Framework, but remain to be determined in the legislative process.

Individual Tax Revisions

For the individual income tax, the plan would broaden the base by disallowing most itemized deductions except for mortgage interest and charitable contributions deductions. It would replace the current seven rate brackets (ranging from 10% to 39.6%) with three brackets, with tax rates of 12%, 25%, and 35% (with the possibility of another higher rate for the highest-income taxpayers). The rate brackets widths are not specified. It would alter some of the elements related to family size and structure by eliminating personal exemptions, allowing a larger standard deduction ($24,000 for joint returns and $12,000 for singles), increasing the child credit by an unspecified amount, and adding a $500 credit for non-child dependents. (The current personal exemption is $4,050 and the current standard deductions are $12,700 for joint returns and $6,350 for single returns.) The current $1,000 child credit would not be altered except through a higher income phase-out range, but only that part of the child credit would be refundable. The alternative minimum tax would be repealed.

The current earned income credit is not mentioned. There is no discussion of the tax treatment of capital gains and dividends. Special provisions for education and retirement would be retained but might be modified.

The Framework also envisions a measure of inflation that the proposal's sponsors deem more accurate to index rate brackets and other parameters such as the standard deduction. While the Framework does not specify this measure, it likely refers to the chained CPI which adjusts the ordinary consumer price index to recognize the substitution of goods when relative prices change. While many economists believe this measure is a better measure of inflation, using it would have the effect of raising taxes compared to using the regular CPI.

Many of these elements (although not changing the inflation measure) were present in the "Better Way" blueprint, although the blueprint had a top rate of 33%. Bracket widths were specified, along with the increase in the child credit ($500) and treatment of head-of-household returns (heads of households would now use the singles rate schedule and have a standard deduction of $18,000, compared to $9,350 under current law). In the "Better Way" plan, capital gains, dividends, and interest would be taxed at 50% of ordinary rates; currently, capital gains and dividends are subject to a top rate of 20% and interest is taxed at ordinary rates.

Tax Provisions Affecting Businesses

The Framework would reduce the corporate tax rate from 35% to 20% and provide for a maximum 25% tax rate for small and family-owned businesses that are taxed under the individual income tax as pass-throughs. Pass-throughs are organized as proprietorships, partnerships, or Subchapter S corporations (corporations that have a small number of shareholders and elect to be taxed at individual rates). The language in the Framework suggests that this rate would apply to all income from business, whether labor or capital income. It does not define small business.

The "Better Way" blueprint had the same rate; it applied the 25% rate to all pass-through businesses but only to capital income. The treatment in the Framework is more consistent with the proposals released by the President as a candidate.

The Framework provides that investment in equipment (but not structures) that is currently recovered, in part, over a period of years, be expensed (deducted immediately) for at least five years. Deductions for interest for corporations would be partially limited, and interest deductions for pass-throughs would be considered by committees. A much more sweeping change was proposed in the "Better Way" plan, where both equipment and structures were to be expensed as permanent provisions and interest deductions disallowed.

The Framework would repeal the production activity deduction, other unspecified deductions, and most credits, but explicitly retain the research credit and the low-income housing credit. The "Better Way" plan also had unspecified changes, repealed the production activity deduction, and retained the research credit.

International Business Tax Provisions

Under current law, worldwide income of U.S. multinationals is taxed, but the tax on earnings of foreign subsidiaries is delayed until the income is repatriated (paid as dividends to the U.S. parent). Firms may take a credit against U.S. tax for taxes paid to foreign jurisdictions. U.S. firms have accumulated a large amount of untaxed earnings abroad, including a significant share held in cash and cash-like assets.

The Framework moves to a territorial tax (where foreign source income would not be subject to regular U.S. tax). The Framework also has a deemed repatriation of existing accumulated income subject to tax at an unspecified rate. The rate would be lower on earnings invested in illiquid form than on earnings in cash or cash equivalents. A territorial tax encourages more profit-shifting (artificially moving profits abroad) and the Framework would impose a reduced rate on foreign profits on a global basis to address this issue. It would also make unspecified changes to address treatment of foreign-headquartered and U.S.-headquartered firms (possibly to address profit shifting by foreign parents of U.S. firms outside of the United States).

While the "Better Way" blueprint moved to a territorial tax and provided a deemed repatriation of existing untaxed income accumulated abroad, it had a wholly different, and likely highly effective, method of preventing profit shifting through a border adjustment. The border adjustment would tax imports and exclude exports, making the payment of tax dependent on the production for consumption in the United States. The border adjustment proved to be controversial and the formulators of the Framework indicated early on that it would not be a part of the new proposal.

The Estate Tax

The Framework repeals the estate tax as did the "Better Way" blueprint. Neither plan mentioned the gift tax, which, presumably, would also be eliminated (otherwise the system would discourage inter-vivos giving).

Revenue, Economic, Distributional, and Administrative Issues

With so many details to be determined, it is not possible to determine most effects. However, the similarity in many ways to the "Better Way" blueprint may provide some insights.

The Committee for a Responsible Federal Budget has estimated that the elements of the plan that have been advanced (making some assumptions about parts not specified, such as bracket widths and tax expenditures to be repealed) would reduce revenues by $2.2 trillion through 2027. Including interest costs, the increase in the debt would be $2.7 trillion. The Urban-Brookings Tax Policy Center has estimated that the proposal would reduce revenues by $2.4 trillion in the first 10 years and $3.2 trillion in the next 10 years. These estimates are rough and preliminary. Better estimates cannot be provided without additional details.

Studies of the "Better Way" blueprint that allowed for crowding out (increased borrowing to finance the debt takes away funds for private investment) generally found this effect outweighed any effect on investment from supply-side incentives.

The Framework would appear to reduce some distortions in the current system, such as that between debt and equity, and have mixed effects on taxes across asset types (equipment investment would be more favored relative to investment in structures than is already the case, as long as it is expensed, but be brought closer to the treatment of intangible investments).

A territorial tax with a minimum tax rate eliminates the disincentive to repatriate foreign source income, but has the possibility of increasing profit shifting, depending on the level and design of the minimum rate. The effects on capital inflows from abroad are uncertain in direction, since lower rates and expensing reduce the tax on equity capital but also reduce the subsidy for debt, an effect that would be increased if some interest deductions are disallowed.

Assuming a child credit and head-of-household treatment the same as in the "Better Way" plan and the same bracket widths, lower- and middle-income taxpayers would generally have either no change in taxes or small tax cuts. Higher-income taxpayers were taxed at about the same rates under the "Better Way" blueprint if all of their income were from wages or labor income. The Framework might confer more benefits on the labor income of higher-income individuals with businesses because the top rate applies to labor earnings of businesses. In some activities (such as activities of attorneys and doctors) most of the business income is from labor income. Both plans reduce the tax burden on capital income through the reduction in corporate and business tax rates, with the caveat that the magnitude of the reduction depends on how interest is treated.

The Urban-Brookings Tax Policy Center has estimated average increases or decreases in after-tax income for most taxpayers of less than one-half of 1% for the bottom 95% of the income distribution with gains of about 2% for the top 95%-99% and around 9% for the top 1%. As with revenue estimates, these estimates are rough and preliminary; better estimates would require more detail.

Wealthy individuals may also benefit from the repeal of the estate tax.

Some parts of the Framework will simplify the tax code. The share of taxpayers (currently about a third) that itemize should be reduced dramatically due to the restrictions on itemized deductions and the increase in the standard deduction. Other changes may lead to additional administrative and compliance complications. The lower maximum tax rate for pass-throughs could lead to significant complications, most notably the potential for high-income individuals to convert their wage income to business income. The Framework indicates that there would be measures to prevent this activity, but such provisions might be difficult to craft.

Jane G. Gravelle, Senior Specialist in Economic Policy

IF10744

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