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Tax Reform: H.R. 1, Tax Cuts and Jobs Act

The proposed tax reform, Tax Cuts and Jobs Act, H.R. 1, was referred to the House Ways and Means Committee on November 2, 2017, and, following a mark-up, was ordered reported on November 9, 2017. H.R. 1 passed the House on November 16, 2017. The bill contains some elements of the 2016 House tax reform blueprint, the "Better Way."

Individual Tax Revisions

The bill would replace the current seven rate brackets (10%, 15%, 25%, 28%, 33%, 35%, and 39.6%) with four brackets, with tax rates of 12%, 25%, 35%, and 39.6%. The rate brackets indicate that income currently taxed at the first two rates would be taxed at 12%. Most taxable income in the 25% and 28% brackets would be taxed at 25%. The current top rate of 39.6% applies to taxable income above $470,700 but would not apply until $1 million of taxable income in the bill. The benefit of the 12% bracket, compared to the 39.6% rate, will be phased out for incomes over $1.2 million.

The bill 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 for 2017, adjusted to $24,400 for joint returns and $12,200 for single returns in 2018), and increasing the current child credit of $1,000 by $600 (although the addition credit would be nonrefundable). A nonrefundable credit of $300 for nonchild dependents and the taxpayers (two credits for a joint return) would be allowed, although the taxpayer credit expires after 2022. (The current personal exemption is $4,050 per person for 2017, and the current standard deductions are $12,700 for joint returns and $6,350 for single returns.) The credits, including the current $1,000 child credit, would be phased out at higher income levels of $115,000. The alternative minimum tax would be repealed.

For the individual income tax, the bill would broaden the base by disallowing most itemized deductions except for mortgage interest (limited to interest on mortgages of $500,000 rather than $1 million), charitable contributions deductions, and state and local taxes on real property (up to $10,000). The deductions for state and local income taxes, medical expenses, employee business expenses, casualty losses (except for specified national disasters), and other minor provisions would be eliminated. Some above-the-line deductions are eliminated, including moving expense deductions (other than for members of the armed forces) and alimony (although alimony will be taxed to the recipient, and current divorce decrees will not necessarily be covered).

The current earned income credit and tax rates on capital gains and dividends are not changed, although capital gains rates would be available for carried interest only if held for three years. The credit for the elderly and disabled and for electric vehicles would be repealed, although the former would be restored after 2020.

Education benefits would be modified and reduced in size by eliminating deductions for interest on student loans and modifying and combining other provisions (such as tax credits and education savings accounts). Some items currently excluded from income would be included; for example, some employer fringe benefits and gain from sale of a home for those who have lived in their homes less than five years. The gain on home sales exclusion would be phased out dollar-for-dollar for individuals with earnings over $500,000 ($250,000 for single returns). Some minor changes would be made in the treatment of pensions and individual retirement accounts.

The bill also uses the chained Consumer Price Index (CPI) measure of inflation to index rate brackets and other parameters, such as the standard deduction. Although many economists believe this measure is a better measure of inflation, using it would have the effect of raising taxes compared with using the regular CPI.

Tax Provisions Affecting Businesses

The bill 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. It would also phase in a lower 9% rate in lieu of the 12% rate, which would be phased out with income. Pass-throughs are organized as proprietorships, partnerships, or Subchapter S corporations (corporations with a small number of shareholders that elect to be taxed at individual rates). For active investors the lower rate would apply only to capital income, designated as 30% of earnings. However, an alternative measuring of capital income as 7% plus the federal short-term rate times assets could be used for capital-intensive firms. Passive investment would be considered capital income.

Under current law, up to $500,000 in equipment can be expensed, phased out after $2 million in spending. The bill would increase the limit to $5 million with a phase out after $20 million. The bill allows all equipment to be expensed through 2022. Deductions for excess interest for corporations would be more limited than in present law.

The bill would require research and experimental expenditures to be deducted over five years rather than expensed (deducted immediately). It would repeal the production activity deduction. It disallows carrybacks of net operating loss deductions, pays interest on unlimited carryforwards, but limits the deduction to 90% of taxable income. It would limit or repeal a variety of other deductions and credits (e.g., the orphan drug credit, certain energy credits, credits for rehabilitation, the work opportunity tax credit, and credits and deductions for employee benefits). It would retain the research credit and the low-income housing credit and allow like-kind exchanges for real estate but not for other property. It would restrict a number of provisions for insurance companies.

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, although these credits are limited to U.S. tax due. Credits from high-tax jurisdictions can be used to offset U.S. tax on income from low-tax jurisdictions (cross-crediting). U.S. firms have accumulated a large amount of untaxed earnings abroad, including a significant share held in cash and cash-like assets.

The bill moves toward a territorial tax (where foreign source income would not be subject to regular U.S. tax). The bill also has a deemed repatriation of existing accumulated income subject to tax of 14% for cash and 7% for earnings invested in illiquid form. A territorial tax encourages more profit-shifting (artificially moving profits abroad) and the bill would tax, on a current basis, half of high-income earnings in excess of a return (7% plus the federal short-term rate) on tangible assets. The bill would also deal with profit shifting by leveraging and other approaches, such as the payment of high royalties from U.S. firms to foreign affiliates, by limiting the share of global interest deducted by firms with foreign affiliates to 110% of their share of income and imposing a 20% tax on deductible payments of U.S. firms to foreign affiliates unless they elect to treat the income as U.S. source.

The foreign tax credit would be largely eliminated, but would be retained for income subject to taxation, including branch income and income taxed under anti-abuse rules already in existence. The credit would be allowed for the high return earnings (taxed at 10%) for 80% of foreign tax credits, with this income separated to prevent cross crediting, and against the tax on payments for 80% of credits.

The Estate and Gift Tax

The current estate tax exemption of $5.49 million (which is adjusted for inflation) will be doubled, and repealed after 2024. Stepped up basis (which allows the heir to exclude any gain accrued to the estate during the decedent's life) would be retained. The gift tax would be retained with the doubled exemption and a lower rate of 35% (from 40%).

Revenue, Economic, Distributional, and Administrative Issues

The Joint Committee on Taxation has estimated a 10-year revenue loss from FY2018 to FY2027 of $1.437 trillion from the bill.

The bill 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 some intangible investments).

The economic effects of the tax cut would likely be small in the longer run and eventually contractionary through the crowding out of investment from increased debt, although there may be some increase in output in the short term from demand stimulus.

A territorial tax would tend to increase profit shifting, although the base erosion provisions aimed at reducing it could offset that effect to some extent. The change eliminates the disincentive to repatriate foreign source income. 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.

The JCT has provided estimates of effective tax rates by income class before and after the bill. Converting these estimates to percentage changes in income after tax for 2019, the overall increase in income after the current federal income tax is 1.6%. For incomes under $40,000, it ranges from 0.5% to 0.8%; for incomes of $40,000 to $50,000, it is 1%; for incomes of $50,000 to $500,000, it ranges from 1.4% to 1.6%; for incomes of $500,000 to $1 million it is 2.2%; and for incomes over $1 million it is 3.9%.

For 2027, the overall increase in income is 0.6%. For incomes under $40,000, it ranges from 0% to 0.5% (the $20,000 to $40,000 group has no tax reduction); for incomes from $40,000 to $50,000, 0.2%; for incomes from $50,000 to $500,000, from 0.5 to 0.8%; for incomes from $500,000 to $1 million, 1.0%; and for incomes over $1 million it is 2.2%. The smaller benefits over time reflect, in part, the inflation adjustment.

Equity and fairness concerns might also be raised about the elimination of the medical expense deduction, since taxpayers with extraordinary medical expenses generally have a lower ability to pay. Eliminating itemized deductions for casualty losses, employee business expenses, and investment expenses result in an overstatement of income for affected taxpayers.

Some parts of the bill will simplify the tax code. The share of taxpayers (currently about a third) who itemize will likely be reduced significantly due to the restrictions on itemized deductions and the increase in the standard deduction. The elimination of exclusions of fringe benefits could complicate compliance, but the elimination of an array of deductions and credits could reduce it. The low tax on capital income of pass-throughs may lead to complication as well.

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