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Tax Reform: The Senate Tax Proposal

The Tax Cut and Jobs Act (H.R. 1) was passed by the Senate on December 2, 2017. The bill contains some elements of the House tax reform blueprint, the "Better Way," released in 2016.

Individual Tax Revisions

In general, the individual tax revisions would expire after 2025, except for the change in inflation indexing and the reduction in penalties for not having health insurance.

The bill would replace the current seven rate brackets (10%, 15%, 25%, 28%, 33%, 35%, and 39.6%) with tax rates of 10%, 12%, 22%, 24%, 32%, 35%, and 38.5%. The rate brackets indicate that the 10% rate will apply to about the same amount of taxable income as in current law and that the income currently taxed at 15% would be taxed at 12%. The current top rate of 39.6% applies to taxable income above $470,700, but the 38.5% rate in the bill would not apply until $1 million of taxable income for joint returns of married couples ($500,000 for other returns).

The bill would alter some of the elements related to family size and structure by eliminating personal exemptions and allowing a larger standard deduction, $24,000 for joint returns and $12,000 for singles for 2018, adjusted for inflation for the following years. The bill would increase the current child credit of $1,000 by $1,000 (although the additional credit would be nonrefundable). The age limit would be increased by a year to under 18 through 2024. The maximum share refundable would be indexed for inflation. A nonrefundable credit of $500 for non-child dependents would be allowed. The credits would be phased out at higher income levels of $500,000 for joint filers. 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. Exemptions for the alternative minimum tax would be increased by 40% (for example, from $78,750 to $109,400 for joint returns).

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 $1 million as in current law but with no deduction for interest on home equity loans), property taxes (up to $10,000), charitable contributions deductions, and medical expense deductions (lowering the floor from 10% to 7.5% of income). The deductions for other state and local taxes, casualty losses (except for certain disasters), and other minor provisions would be eliminated. The moving expense deduction (an above-the-line deduction) would be eliminated (other than for members of the armed forces).

The current earned income credit and tax rates on capital gains and dividends are not changed.

Some items currently excluded from income would be included—for example, the employer-provided exclusion for moving expenses and gain from sale of a home for those who have lived in their homes less than five years.

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 that this measure is a better measure of inflation, using it would have the effect of raising taxes compared with using the regular CPI.

The bill would reduce penalties for not purchasing health insurance to zero.

Tax Provisions Affecting Businesses

Some of these provisions would expire after 2025, including the deduction for unincorporated businesses.

The bill would reduce the corporate tax rate from 35% to 20% and allow a 23% deduction for businesses that are taxed under the individual income tax as pass-throughs, including proprietorships, partnerships, or Subchapter S corporations (corporations with a small number of shareholders that elect to be taxed at individual rates). The 23% deduction sunsets after 2025. The deduction does not apply to specified service businesses (such as health or law) except for those under a taxable income ceiling of no more than $500,000 for a joint return and $250,000 for others. The deduction applies to qualified business income and does not include amounts paid by an S corporation as compensation or amounts distributed by a partnership for services. For partnerships or S corporations, the deduction is limited to 50% of wages allocable to business income for those above the taxable ceiling. Business losses that can be passed through are limited to $500,000 for joint returns and $250,000 for others, indexed for inflation.

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 $1 million with a phase-out after $2.5 million. The bill allows all equipment to be expensed through 2022 with public utility property excluded, with a phase-out of the share expensed over the next four years (80%, 60%, 40% and 20%). Nonresidential real property and residential rental property could be depreciated over 25 years. Qualified leasehold, qualified restaurant, and qualified retail improvement property could be depreciated over 10 years. Deductions for excess interest for corporations would be more limited than in present law. Research and experimentation costs would be depreciated over five years rather than expensed, after 2025.

The bill would repeal the Section 199 production activity deduction. It would disallow carrybacks of net operating loss deductions, allow unlimited carryforwards, and limit the deduction to 80% of taxable income after 2023. It would limit or repeal a variety of other deductions and credits (e.g., the orphan drug credit, credits for rehabilitation, and deductions for meals and entertainment and transportation fringe benefits, and FDIC payments). 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.

The corporate alternative minimum tax is retained.

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 14.5% for cash and 7.5% for earnings invested in illiquid form. (A tax of 35% is imposed retroactively if a firm inverts within 10 years.) A territorial tax encourages more profit-shifting (artificially moving profits abroad), and the bill would tax, on a current basis, global intangible low taxed income (GILTI) in excess of 10% of assets. Foreign derived intangible income, including GILTI, would be eligible for a 37.5% deduction, with the deduction for foreign derived intangible income reduced to 21.875% after 2025. The bill would also deal with profit-shifting by limiting the share of global interest deducted by firms with foreign affiliates to 110% of their share of assets (phased in over four years beginning at 130%). The proposal also provides a special rule to limit the value of intangible property distributed to the U.S. firm. A 10% tax, increased to 12.5% after 2025, is imposed on deductible payments to related foreign parties by U.S. firms (the base erosion and anti-abuse tax), with some exceptions for service payments.

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, although a separate limit on the foreign tax credit would be applied to branch income and to GILTI (so that cross-crediting—that is, using excess credits from one type of income to offset U.S. tax due on another type—could not occur).

The Estate and Gift Tax

The current estate tax exemption of $5.49 million (which is adjusted for inflation) would be doubled, with the increase expiring after 2025.

Revenue, Economic, Distributional, and Administrative Issues

The Joint Committee on Taxation (JCT) has estimated a 10-year revenue loss from FY2018 to FY2027 of $1.448 trillion from the bill, with a gain in 2027.

The bill would appear to reduce some distortions in the current system, such as that between debt and equity, and across different asset types. A macroeconomic analysis of the bill as originally reported out of committee showed an offset of 32% of the revenue loss from economic growth of 0.08% per year.

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, because 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 before and after the tax change for the bill as reported out of the Finance Committee. Converting these estimates to percentage changes in income after tax for 2019, the overall increase in after-tax income is 2%. For incomes under $40,000, it ranges from 0.3% to 0.8%. For incomes of $40,000 to $50,000, it is 1.1%. For incomes of $50,000 to $200,000, it is 1.5% to 1.8%. For incomes from $200,000 to $500,000, it is 2.9%. For incomes of $500,000 to $1 million, it is 4.5%. For incomes over $1 million, it is 3.1%.

For 2027, the JCT estimates no overall increase in after-tax income. For incomes under $50,000, it ranges from -0.3% to -1.5% (higher taxes). For incomes from $50,000 to $500,000, it ranges from -0.1% to 0.1% (a negligible change). For incomes from $500,000 to $1 million, after tax income increases by 0.4% and for incomes over $1 million, it increases by 0.6%. The smaller benefits or increased taxes over time reflect, in part, the inflation adjustment, as well as the sunset of individual tax changes.

Equity and fairness concerns might also be raised about the elimination of itemized deductions for casualty losses and employment and investment expenses that can result in an overstatement of income for affected taxpayers. Equity issues might also be raised about allowing state and local income tax deductions for corporations and not individuals.

Some parts of the bill will simplify the tax code. The share of taxpayers (currently about a third) that itemize will likely be reduced significantly due to the restrictions on itemized deductions and the increase in the standard deduction. The deduction for capital income of pass-throughs may lead to complications as individuals try to re-characterize income to be eligible for the deduction.

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