Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

December 19, 2017

Tax Cuts and Jobs Act (H.R. 1): Conference Agreement

The Tax Cut and Jobs Act (H.R. 1) was released by the conference committee on December 15, 2017. The bill contains some elements of the House tax reform blueprint, the "Better Way," released in 2016.

Individual Tax Revisions

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 37%. 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 37% rate in the bill would not apply until $600,000 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 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, all indexed.

The bill would increase the current child credit of $1,000 by $1,000 with up to $1,400 refundable (against up to 15% of income over $2,500). The $1,400 limit, but not other elements, 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 $400,000 for joint filers ($200,000 for others). Exemptions for the alternative minimum tax would be increased by 40% (for example, from $78,750 to $109,400 for joint returns), and indexed.

For the individual income tax, the bill would broaden the base by disallowing itemized deductions except for mortgage interest (limited to interest on mortgages of $750,000 and with no deduction for interest on home equity loans); state and local income, property, and sales taxes (up to $10,000); charitable contributions deductions; and medical expense deductions (lowering the floor from 10% to 7.5% of income for 2017 and 2018). 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.

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.

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.

Tax Provisions Affecting Businesses

The bill would reduce the corporate tax rate from 35% to 21% and allow a 20% 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 deduction applies to business income and 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. The deduction is limited to the greater of 50% of wages paid or the sum of 25% of wages paid plus 2.5% of the basis of tangible assets. The service business exclusion and the limits based on wages and assets would apply only after taxable income reached $315,000 for a joint return and $157,500 for others with these amounts phased out (completely at $415,000 and $207,500, respectively). 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 (public utility property would be excluded), with a phase-out of the share expensed over the next four years (80%, 60%, 40%, and 20%). 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 2021.

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. 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 would be repealed.

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 (with dividends deducted). The bill also has a deemed repatriation of existing accumulated income subject to tax of 15.5% for cash and cash equivalents and 8.0% 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 tangible assets at a 10.5% rate. Foreign derived intangible income earned in the United States would be taxed at 13.125%. The bill would not include a provision limiting the share of global interest deducted by firms with foreign affiliates to 110% of their share of assets or income as proposed in the original House and Senate bills. A 10% alternative tax, increased to 12.5% after 2025, is imposed on the sum of deductible payments to related foreign parties by U.S. firms (base erosion payments and taxable income) and is paid if higher than regular tax before most credits.

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 $1.456 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 House and Senate bills showed an offset of about a third of the revenue loss from average economic growth of 0.07% to 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 act would eliminate 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 conference agreement. Converting these estimates to percentage changes in income after tax for 2019, the overall increase in after-tax income is 2.1%. For incomes under $40,000, it ranges from 0.5% to 1.0%. 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 1.9%. For incomes from $200,000 to $500,000, it is 3.4%. For incomes of $500,000 to $1 million, it is 4.5%. For incomes over $1 million, it is 3.4%.

For 2027, the JCT estimates no overall increase in after-tax income. For incomes under $50,000, it ranges from -0.4% to -1.5% (higher taxes and lower incomes). For incomes from $50,000 to $200,000, it ranges from -0.1% to 0.1%. For incomes from $200,000 to $500,000, it increases by 0.3%; for incomes from $500,000 to $1 million, 0.4%; and for incomes over $1 million, 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 but not fully for individuals. Some parts of the act would 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 recharacterize income to be eligible for the deduction.

Jane G. Gravelle, Senior Specialist in Economic Policy

IF10792

Disclaimer