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What Workers and Companies Should Know About the Republican Tax Bills

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The House and Senate have passed somewhat different versions of major legislation to restructure the federal income tax. A House-Senate conference committee still needs to reconcile the two bills, with the goal of finishing before Christmas. Both bills would significantly overhaul the corporate income tax, increase the federal budget deficit, and disproportionately benefit upper-income taxpayers. And the bills include many provisions that are poorly understood and may have unintended consequences.

The legislation would dramatically change how both companies and individuals pay taxes. Here are the broad strokes of the bills, as of this writing, some of which are more positive than others.

Corporate Tax Reform

The bills would reduce the federal statutory corporate tax rate to 20% (which translates to about 25% including state corporate income taxes), putting the U.S. statutory corporate rate more in line with our major trading partners and reducing many of the disincentives that cause companies to invest and report income elsewhere and establish tax residence outside of the United States. By eliminating the tax on repatriated dividends that U.S. companies receive from their foreign affiliates, the bills remove the incentive for U.S. corporations to accumulate assets in those affiliates (now estimated at $2.6 trillion), enabling them to manage their portfolios more efficiently. The legislation would replace the tax on profits that are repatriated with a low-rate tax on annual profits attributable to the intangible assets of their foreign affiliates, impose a one-time transition tax on the stock of accrued foreign profits of U.S. companies, and include provisions aimed at protecting the U.S. tax base from profit stripping by foreign-based companies investing in the United States.

The reforms of corporate and international taxation are broadly consistent with proposals from leaders in both parties in recent years. Whether their complex provisions to protect the U.S. tax base will be effective and what collateral harm they may cause remains to be seen. And because the corporate proposals lose revenue, it's impossible to fully assess this part of the legislation without considering how those cuts would eventually be financed.

Revenue and Distribution

The Joint Committee on Taxation (JCT) estimates, using conventional scoring, that the bills would reduce federal tax receipts by about $1.5 trillion over 10 years. Proponents have claimed that the tax cuts would pay for themselves with higher revenue from economic growth, but analyses by the JCT, the Tax Policy Center (TPC), Penn-Wharton, and other economic modelers find that revenue feedbacks from increased output would offset only a small fraction of the budgetary costs. Yes, tax cuts can cause modest economic growth under the right circumstances, but nowhere near enough to make up for all the lost tax revenue from these bills.

To meet the Senate's self-imposed requirement that the tax bill cannot increase the deficit after 10 years, the Senate bill would repeal most of its individual tax changes by the end of 2025. (If Congress is to pass a final bill with only Republican votes, as the Republican leadership contemplates, it must not increase the deficit after 10 years in order to comply with the Senate's reconciliation rules.) The only two permanent individual income tax changes would be to 1) adjust the tax code's indexing formula so that individuals move more rapidly into higher tax brackets over time and 2) eliminate the penalty tax associated with the individual mandate to purchase health insurance in the Affordable Care Act (ACA). Removing the penalty tax reduces the deficit because fewer individuals would receive Federal subsidies for insurance purchased on the exchanges and fewer also would sign up for Medicaid benefits. (The Congressional Budget Office estimates that it would also substantially increase the number of people without health insurance coverage.)

Both bills provide relatively larger benefits to upper-income taxpayers than to lower and middle-income households. TPC estimates that, in 2027, the House bill would increase after-tax income on average by 2.6% for tax units in the top 1% of the income distribution, compared with 0.5% in the middle quintile, and 0.1% for the lowest quintile. Because the Senate bill sunsets most individual income tax provisions after 2025, while leaving the corporate tax cut unchanged, it would have two major effects. Its total net tax cut would be much smaller in 2027 and, because the corporate tax changes would mostly benefit shareholders and other recipients of investment income, the tax cut would be more concentrated at the high end of the income distribution. After-tax income would increase by 1.1% for tax units in the top 1%, compared with an increase of 0.1% for the middle quintile and a decrease of 0.1% for the bottom quintile. Tax units in the top 1% of the income distribution would receive over 60% of the benefits from the tax cuts, excluding repeal of the penalty associated with the individual mandate, which would negatively affect tax lower-income households.

Changes in the Tax Base

The tax bills reshuffle tax burdens within income groups, creating winners and losers, but with no obvious organizing principle behind the changes. Both bills nearly double the standard deduction, increase child tax credits, and eliminate personal exemptions. The House and Senate bills eliminate some deductions, retain others, and introduce some new ones. The biggest change is the elimination of the deduction for state and local taxes, except for the first $10,000 of property taxes. Both Houses would lower taxes on income from "pass-through businesses" such as partnerships and sole proprietorships. The Senate would tax pass-through income at a maximum rate of 25%, compared with a rate of 39.6% for ordinary income for the highest bracket of individuals. The House would allow a deduction for 23% of pass-through income, creating a top rate equal to 29.6%, almost 10 percentage points lower than its proposed top rate of 38.5% for earnings.

Unrecognized Consequences

The bills are so complex that they will likely have consequences the legislators may not have intended. The special treatment of pass-through income would create incentives for firms to use independent contractors instead of employees and for business owners to arrange to receive their compensation in the form of profits instead of wages. While both bills try to limit access to the special pass-through rates, tax planners may develop strategies to avoid those limits. By raising the standard deduction and limiting the deduction for state and local taxes, the bills would greatly reduce the number of itemizers and largely limit them to high-income households. As a result, the bills would reduce incentives for people to make charitable contributions or take on high mortgage debt. The Senate's last-minute decision to retain the corporate alternative minimum tax (AMT), combined with the reduction in the corporate rate, would greatly expand the reach of the AMT. With the AMT and regular corporate rates now equal, and the AMT base broader, virtually all corporate taxpayers would pay the AMT. This would reverse the reforms that establish a territorial tax and eliminate some other tax incentives, including the research credit. Because commentators have raised awareness of these effects, it is likely that the conference will restore the AMT repeal. But other consequences remain unrecognized - a result of rushing through a complex bill without giving outside experts, interest groups, or even government staff time to understand all the ramifications.

One thing is certain: While the tax bill is unlikely to create the millions of jobs its sponsors have promised, it will be great for the employment of tax practitioners and analysts. From my self-interested viewpoint as one of those analysts, I can only applaud.

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