



HOW DID THE TAX CUTS AND JOBS ACT CHANGE TAX EXPENDITURES?

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The 2017 Tax Cuts and Jobs Act reduced tax expenditures but by much less than the Tax Reform Act of 1986, relative to the size of the economy. The largest reductions in tax expenditures were for deductibility of nonbusiness state and local taxes and the preferential treatment of active foreign-source income of controlled foreign corporations. There were sizeable reductions in other tax expenditures as well including the deductibility of mortgage interest on owner-occupied homes, the exclusion of employer contributions for medical insurance premiums and medical care, and the deductibility of charitable contributions. These decreases were offset in part by increases in some existing tax expenditures and the enactment of some new ones. The largest tax expenditure increases were the expansion of the child credit, the new 20-percent deduction for income from pass-through businesses, and 100 percent bonus depreciation.

In this report, we review the major changes from the new law to individual (nonbusiness) and business tax expenditures. The former category includes tax expenditures in the individual income tax except those that apply to business income, while the latter category includes tax expenditures in the corporate income tax and those in the individual income tax that apply to pass-through businesses.

INDIVIDUAL (NONBUSINESS) TAX EXPENDITURES

The Tax Cuts and Jobs Act (TCJA) eliminated or reduced some individual tax expenditures and increased others. The decreases in tax expenditures, other than the deduction for state and local government taxes, were mostly a result of indirect effects from other provisions of the TCJA, rather than through direct changes in those provisions. The increase in the standard deduction, which reduced the number of taxpayers itemizing their deductions and the tax benefits from itemizing, was responsible for most of the decline in the tax expenditures for mortgage interest and charitable contributions, though the new limit on the deductibility of state and local taxes also contributed by reducing the number of itemizers. Lower individual income tax rates, which reduce the value of exclusions and deductions, was another factor.

In table 1, we compare nonbusiness tax expenditure estimates for fiscal year 2019 by the congressional Joint Committee on Taxation (JCT) and the US Treasury Department's Office of Tax Analysis (OTA) before and after the passage of the TCJA.

TABLE 1

Largest Changes in Individual (Nonbusiness) Tax Expenditures

Estimates for fiscal year 2019, before and after passage of TCJA, billions of dollars



| Tax expenditure item | JCT | | | OTA | | |
|---|----------------|---------------|---------|----------------|---------------|----------|
| | Before TCJA | After TCJA | Change | Before TCJA | After TCJA | Change |
| Largest Decreases | | | | | | |
| Deduction for nonbusiness state and local government taxes | \$116.5 | \$21.5 | -\$95.0 | \$118.4 | \$17.4 | -\$101.0 |
| Deduction for mortgage interest on owner-occupied residences | \$78.7 | \$27.4 | -\$51.3 | \$74.5 | \$26.9 | -\$47.7 |
| Deduction for charitable contributions | \$60.1 | \$40.9 | -\$19.2 | \$64.4 | \$43.0 | -\$21.4 |
| Exclusion of employer contributions for medical insurance premiums and medical care | \$180.6 | \$164.1 | -\$16.5 | \$242.9 | \$203.3 | -\$39.6 |
| Subsidies for insurance purchased through health benefit exchanges ^a | \$77.9 | \$53.2 | -\$24.7 | \$40.9 | \$43.4 | \$2.4 |
| Largest Increases | | | | | | |
| Credit for children and other dependents ^a | \$53.6 | \$121.2 | \$67.6 | \$54.0 | \$130.5 | \$76.6 |

Sources: Joint Committee on Taxation (JCT), "Estimates Of Federal Tax Expenditures For Fiscal Years 2018-2022" and "Estimates Of Federal Tax Expenditures For Fiscal Years 2016-2020," October 2018; U.S. Department of the Treasury, Office of Tax Analysis (OTA), "Tax Expenditures," Fiscal Years 2019 and 2020, October 2018.

Notes: Amounts reflect total for individuals only. (a) Includes outlay effects.

The individual tax expenditures that declined the most for fiscal year 2019 are (1) the deduction for nonbusiness state and local income, sales, and property taxes; (2) the deduction for mortgage interest on owner-occupied homes; (3) the deduction for charitable contributions; and (4) the exclusion of employer contributions for medical insurance premiums and medical care (table 1). The tax expenditure for premium subsidies for health insurance purchased through exchanges created by the Affordable Care Act also fell substantially according to estimates from the JCT, but not according to the OTA. The largest tax expenditure increase was for the child tax credit.

CHANGES TO SPECIFIC TAX EXPENDITURES

Deduction for state and local taxes. The TCJA capped the total state and local tax (SALT) deduction at \$10,000 per return. Further, the law reduced the number of taxpayers claiming the SALT deduction by nearly doubling the standard deduction, and it reduced the benefit for those continuing to claim the deduction by lowering marginal individual income tax rates. These effects were partially offset for higher-income taxpayers by an increase in the exempt amount under the individual alternative minimum tax, which reduced the number of filers subject to the alternative minimum tax, which disallows the SALT deduction.

Deduction for mortgage interest. The TCJA limited the deduction of home mortgage interest to interest on up to \$750,000 of mortgage debt (reduced from the pre-TCJA limit of \$1 million of mortgage debt) for mortgage loans taken out after December 15, 2017. Homeowners may still deduct mortgage interest on their primary residence and a second home. These changes had a modest effect on the cost of the tax expenditure, however. The reduced cost of the mortgage interest deduction is largely caused by the indirect effects of the higher standard deduction, the cap on the SALT deduction, and reduced marginal tax rates.

Deduction for charitable contributions. The TCJA increased the limit on deductions for charitable contributions from 50 percent to 60 percent of adjusted gross income. Despite raising the limit, the cost of this tax expenditure declined because of the same indirect effects as for the mortgage interest deduction.

Other itemized deductions. The TCJA eliminated some smaller itemized deductions including those for unreimbursed employee expenses, tax preparation fees, and other miscellaneous deductions and the deduction for theft and personal casualty losses, though taxpayers can still deduct certain casualty losses occurring in federally declared disaster areas. The TCJA made the deduction for out-of-pocket medical expense more generous, allowing taxpayers to temporarily deduct unreimbursed medical expenses and health insurance premiums that exceed 7.5 percent of their adjusted gross income in 2017 and 2018, instead of the 10 percent of adjusted gross income floor in effect before the TCJA. The floor was scheduled to permanently return to 10 percent of adjusted gross income starting in 2019, but legislation enacted in 2019 extended the 7.5 percent floor through 2020.

Exclusion of employer contributions for medical insurance and medical care. The TCJA reduced the cost of the exclusion of employer contributions for medical insurance and medical care because of the reduction in marginal income tax rates, though the lower cost also may reflect changing assumptions about the growth in health care costs and coverage in the estimates. The JCT and the OTA estimate different costs for this provision because the JCT measures the tax expenditure as the increase in tax liability if the exclusion were repealed but taxpayers could still claim an itemized medical expense deduction for employer paid medical insurance, while the OTA measures the tax expenditure as the increase in tax liability if the exclusion were repealed and employer contributions for medical insurance were fully taxable.

Subsidies for insurance purchased through health benefit exchanges. The decrease in this tax expenditure is due to a different indirect effect. The Congressional Budget Office estimates that the elimination of the penalty tax on people without health insurance will reduce the take-up rate for health insurance plans through the Affordable Care Act exchanges. The resulting reduction in coverage will reduce tax subsidies paid out by the exchanges by about \$24.7 billion in 2019, according to estimates by the JCT. The OTA does not include these savings from the reduced take-up of premium credits in its estimates, so the TCJA did not have much effect on its tax expenditure estimates for this provision.

Child tax credit. The TCJA expanded the child tax credit in several ways. It doubled the maximum credit from \$1,000 to \$2,000 per child starting in 2018. It also increased the refundable portion of the credit but limited the maximum refundable credit to \$1,400 per child. The maximum refundable amount limit is indexed to inflation, but the maximum total credit amount is not. The TCJA also limited eligibility for the credit to children who have a valid Social Security number.

As part of the changes to the child tax credit, the TCJA created a new nonrefundable \$500 credit for other dependents, including children who are too old to be eligible for the child tax credit, full-time college students, other adult members of the household for whom the taxpayer provides significant financial support, and children who would otherwise be eligible for the \$2,000 child tax credit but lack a valid Social Security number. Like the regular child tax credit, the \$500 amount is not indexed to inflation.

The TCJA extended the child tax credit to higher-income families by increasing the income threshold at which the credit phases out, moving it from \$110,000 to \$400,000 for married couples and from \$75,000 to \$200,000 for other taxpayers. As before the TCJA, the income phase-out thresholds are not indexed for inflation.

INDIRECT EFFECTS OF HIGHER STANDARD DEDUCTIONS AND LOWER INCOME TAX RATES

By increasing the standard deduction, the TCJA significantly reduced the value of itemized deductions, which benefit taxpayers the more the sum of their itemized deductions exceeds the standard deduction. The cap on the SALT deduction further reduced the value of itemized deductions by limiting total itemized deductions for taxpayers with more than \$10,000 of deductible state and local taxes. TPC estimates that overall, the TCJA will reduce the number of itemizers from about 46 million to about 19 million.

The TCJA modestly reduced the value of many individual tax expenditures by both reducing some statutory tax rates and expanding tax brackets, resulting in lower marginal tax rates (the tax rate on the last dollar of income) for most taxpayers. Lower marginal tax rates reduce the cost of tax expenditures that take the form of exclusions and deductions because reducing taxable income provides a smaller tax benefit at lower rates.

BUSINESS TAX EXPENDITURES

The TCJA eliminated some business tax expenditures while reducing or increasing others and introducing new ones altogether. The new law also led to changes in the number of taxpayers who benefit from tax expenditure provisions and the value of the benefits they receive. The reductions in individual and corporate income tax rates, which lowered the value of many business tax expenditures, were the most important indirect factors.

In table 2, we compare business tax expenditure estimates for fiscal year 2019 by JCT and the OTA before and after the passage of the TCJA.

TABLE 2

Largest Changes in Business Tax Expenditures

Estimates for fiscal year 2019, before and after passage of TCJA, billions of dollars



| Tax expenditure item | JCT | | | OTA | | |
|--|----------------|---------------|---------|----------------|---------------|---------|
| | Before TCJA | After TCJA | Change | Before TCJA | After TCJA | Change |
| Largest Decreases | | | | | | |
| Reduced tax rate on active income of controlled foreign corporations (formerly deferral) | \$120.5 | \$68.0 | -\$52.5 | \$118.2 | \$34.5 | -\$83.7 |
| Deduction for income attributable to domestic production activities | \$20.6 | ----- | -\$20.6 | \$14.8 | ----- | -\$14.8 |
| Expensing under section 179 of depreciable business property | \$32.9 | \$16.2 | -\$16.7 | \$3.7 | \$1.7 | -\$2.1 |
| Largest Increases | | | | | | |
| 20 percent deduction for qualified business income | ----- | \$48.6 | \$48.6 | ----- | \$53.3 | \$53.3 |
| Depreciation of equipment in excess of alternative depreciation system | \$10.7 | \$71.2 | \$60.5 | \$26.4 | \$68.8 | \$42.4 |

Sources: Joint Committee on Taxation (JCT), "Estimates Of Federal Tax Expenditures For Fiscal Years 2018-2022" and "Estimates Of Federal Tax Expenditures For Fiscal Years 2016-2020," October 2018; U.S. Department of the Treasury, Office of Tax Analysis (OTA), "Tax Expenditures," Fiscal Years 2019 and 2020, October 2018.

Note: Amounts reflect total for corporations and individuals. The TCJA eliminated the deduction for domestic production activities and introduced the deduction for qualified business income

The biggest declines resulted from the TCJA replacing deferral of taxes on the active income of foreign corporations controlled by US companies with a reduced tax rate on that income, eliminating the deduction for income attributable to domestic production activities, and allowing expensing of business depreciable property for small businesses under section 179 of the IRS tax code. The largest increase resulted from the TCJA expanding the existing tax expenditure for accelerated depreciation of equipment. The tax law also created a new business tax expenditure by allowing a 20 percent deduction for qualified business income of pass-through businesses.

CHANGES TO SPECIFIC TAX EXPENDITURES

Reduced tax rate on foreign source income. The TCJA replaced US multinational corporations' ability to defer taxes on the profits of foreign corporations they control with a reduced tax rate on a portion of those profits. As a result of this change, the JCT's estimate shows a reduction in 2019 business tax expenditures of \$52.5 billion, compared with what they would have been without TCJA; the OTA estimate shows a decline of \$83.7 billion.

Both the JCT and the OTA measure the tax expenditure related to foreign earnings of US corporations relative to a baseline or reference tax system in which foreign earnings are taxed at the normal corporate income tax rate when they are earned. Under pre-TCJA law, US multinational companies could defer taxes on the profits of their controlled foreign corporations until those profits were repatriated to the US parent corporation. Before TCJA, the top corporate tax rate was 35 percent. At that rate, the JCT estimated that deferral would cost \$120.5 billion in 2019; the OTA estimate was \$118.2 billion. Under the new law, profits of controlled foreign corporations are not taxed, except for certain income (global intangible low tax income, or GILTI), which is taxed at half the normal 21 percent corporate rate. The JCT estimated that the reduced rate on foreign earnings would cost \$68.0 billion in 2019; the OTA estimated that it would cost \$34.5 billion. (One reason for this difference is that the OTA counts as an offset to this revenue loss the revenue raised by a transition tax that TCJA imposed on profits that U.S. companies accrued in their controlled foreign corporations between the end of 1986 and 2017, while the JCT does not count this temporary revenue as an offset.)

Expensing for small businesses under section 179. Section 179 of the IRS tax code allows small businesses to deduct the full cost of new equipment in the year of purchase. Even though the TCJA made the deduction more generous by increasing the maximum deduction and the phase-out threshold above which the deduction is reduced, the tax expenditure declined because with 100 percent bonus depreciation in place for all businesses (discussed below), the additional cost of expensing under section 179 is much less than it would have been without enacting bonus depreciation.

Deduction for domestic production activities. The TCJA eliminated the deduction for a portion of income from domestic production activities, which the JCT had estimated would cost \$20.6 billion in 2019 before the TCJA and which the OTA had estimated would cost \$14.8 billion. For large corporations, the deduction was equivalent to a cut in the tax rate on profits from domestic production from 35.0 to 31.9 percent under prior law. With the lower corporate tax rate enacted in TCJA, Congress believed this deduction was no longer needed to reduce the tax burden on domestic manufacturing and eliminated it.

Bonus depreciation. The largest increase in a business tax expenditure resulted from the TCJA expanding accelerated depreciation of equipment by businesses. Under the baseline or reference tax system used by the JCT and the OTA, the cost of purchasing equipment would be capitalized and deducted over time to match the decline in the economic value of the equipment. Under prior law, businesses already could deduct the cost of new equipment faster than the rate of economic depreciation. TCJA further sped up depreciation deductions, allowing businesses to deduct the full cost of new equipment in the year of purchase (100 percent bonus depreciation or full expensing) for five years beginning in 2018 (and then phasing out at 20 percent per year beginning in 2023). According to the JCT estimate, full expensing increased the 2019 tax expenditure for accelerated depreciation of equipment by \$60.5 billion; the OTA estimate puts the increase at \$42.4 billion. The annual tax saving from expensing, however, becomes negative in future years as businesses can no longer claim depreciation deductions for equipment they have previously expensed. As a result, the 2019 tax expenditure estimate overstates the subsidy value to businesses of bonus depreciation.

Deduction for qualified business income. The largest business tax expenditure created by the TCJA is a 20 percent deduction for qualified business income received by owners of pass-through businesses (sole proprietorships, partnerships, limited liability companies, and subchapter S corporations). The deduction effectively reduces the top rate on qualified business income (which is taxed according to individual income tax rates) from 37.0 percent to 29.6 percent.

INDIRECT EFFECTS OF LOWER INCOME TAX RATES

Lower marginal tax rates reduce the cost of tax expenditures that take the form of exclusions and deductions because reducing taxable income provides smaller tax benefits at lower tax rates. The TCJA significantly lowered the top corporate income tax rate from 35 to 21 percent, decreasing the value of the corporate income tax exclusions and

deductions. It more modestly reduced the value of business tax expenditures for pass-through businesses by lowering individual income tax rates, but with a much smaller decline in the top individual tax rate from 39.6 to 37.0 percent.

Reductions in corporate and individual income tax rates alone would have reduced the cost of what were the three largest business tax expenditures before the TCJA: deferral of income accrued in controlled foreign corporations, depreciation in excess of the alternative depreciation system, and the domestic manufacturing deduction.

In one case, the lower corporate tax rate was enough to turn what would have been a tax expenditure increase into a decrease. Replacement of deferral with a minimum tax on intangible income in low tax-countries reduced receipts by about \$16 billion in 2019 at the 21 percent corporate rate, so that change alone increased the tax expenditure from preferential treatment of foreign source income. The lower corporate rate thus accounted for more than 100 percent of the reduction in this tax expenditure.

In other instances, the reduction in tax rates offset what would have been an even larger increase in tax expenditures. For example, even though lower tax rates reduced the tax expenditure for accelerated depreciation of investment in equipment, expanding accelerated depreciation to full expensing caused the tax expenditure to go up on net. Likewise, the tax expenditure for the new 20 percent deduction for business income would have been higher had the TCJA not lowered individual income tax rates.

When it comes to the domestic manufacturing deduction, the corporate rate cut on its own would have reduced the tax expenditure but not as much as eliminating it altogether.

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