# Diving into Federal Tax Reform

## NCSL Executive Committee Task Force on State and Local Taxation
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# AGENDA

- Business Tax Reform
- International Tax Reform
- Individual Income Tax Reform
- What Happens Next?

# Federal Income Tax Reform

## Background

– On June 24, 2016, the House Republicans released their vision for tax reform (the Blueprint).

– On April 26, 2017, President Trump released his overall vision for business tax reform.

– On September 27, 2017, the White House and Congressional Republicans released the Unified Framework for Fixing Our Broken Tax Code.

– On November 2, 2017 (amended on November 9), the House Ways and Means federal tax reform legislation "Tax Cuts and Jobs Act" (H.R.1) was released totaling 429 pages.

– On November 9, 2017, the Senate released its federal tax reform proposals.

– **Next up:** Votes in the House and Senate and then a Conference Committee.

# The House and Senate Business Tax Reform Proposals

# Business Tax Reform Proposals

- **Business Tax**
  - Corporate rate reduced from 35% to 20% (Senate: Delay one year to 2019 tax year)
  - **Immediate expensing of business investments in certain new and used assets for five years (JCT: -$84B first five years)**
  - **Limit net interest deductions to 30 percent of ATI (essentially EBITDA) – (JCT:+$172B)**
    - **Senate: similar provision (+$308B)**
  - Limit NOL deduction to 90 percent of ATI: eliminate carrybacks; unlimited carryforward (with interest)
  - **Repeal/restrict special exclusions or deduction (e.g., IRC § 199 domestic manufacturing deduction) (JCT:+95B)**
- **Pass-Through Businesses**
  - **25% capped tax rate; 70% safe harbor for wage income. (JCT: -$448B); 9% rate for some passthrough income**
  - Senate: no rate cap but 17.4% **deduction** for pass-through income

# The House and Senate International Tax Reform Proposals

# International Tax Reform Proposals

- Move from worldwide to territorial tax system
  - 100% exemption for dividends from foreign subsidiaries (at least 10% owned)
  - **Accumulated foreign earnings held overseas treated as repatriated under special Subpart F classification, with a bifurcated rate (14%/7%) for liquid and illiquid assets (JCT:+$293B) (Senate: 10%/5% rates)**
- **Current year inclusion of income with "foreign high returns" (JCT:+$77B)**
- **Excise tax on outbound related party payments; ECI election (+154B)**
- **Limits deduction of interest by members of international financing reporting group (JCT+34B)**
- **Require some R&D expenditures to be capitalized over 15 years for research conducted outside the country (+$70B)**
- **Senate: Has its own base erosion measures ($123B) and a current-year inclusion for global intangible low-taxed income ($115B).**

# The House and Senate Individual Income Tax Reform Proposals

# Individual Income Tax Proposals

- Reduce 7 tax brackets to 4 tax brackets – 12%, 25%, 35% & 39.6% (Senate: keeps 7 tax brackets)
- Eliminate AMT
- Increase standard deduction (approx. double), while eliminating personal exemptions
- **Eliminate most itemized deductions including deduction for state income (and sales) taxes**
  - **Modify home mortgage interest deduction for newly purchased homes (capped at $500k of value; grandfather for existing mortgages); limit property tax deduction to $10,000 (but not foreign); retain charitable deduction (JCT:+$1.26T)**
  - Senate: keeps home mortgage interest deduction intact; eliminates entire state and local tax deduction.
- Eliminate estate tax (Senate keeps estate tax but increases size of estates that qualify for exemption)

# What Happens Next?

# State Impact Based on Conformity to Federal Tax Law

| Federal | States |
|---|---|
| Tax rate reductions | States have own rates |
| Special pass through entity rate | States have own rates (unless change is made as a deduction) |
| Broadened tax base including repeal of many itemized deductions | State conformity |
| Fully expensed investments | State partial conformity |
| Reduced repatriation rate | Modest impact |
| Territorial tax regime | Minimal conformity |
| Tax on high return foreign income and other base erosion measures | State partial conformity |
| Limitation of interest deductions | State conformity |

# What's the Holdup?

- Corporate-only reform that improves competitiveness loses revenue.
- Pass-throughs oppose corporate-only reform.
- Individual tax cuts are very expensive without base broadening.
- Base broadeners are unpopular with those who benefit from them.
- Reconciliation permits tax changes with 50 votes but Byrd Rule precludes *increases to the deficit outside the baseline*.
- Static scoring and 2012 tax plan incoherence led to focus on boosting economic growth (territorial, expensing, permanence)
- House regular order vs. Hastert rule/leadership control of agenda
- Senate filibuster threats
- @realdonaldtrump

# Some Final Observations

- Federal tax reform would result in a significant shifting of tax policy priorities.
  - H. R. 1 has about $5.9 trillion in tax cuts offset by about $4.5 trillion in tax increases.
- **States may experience short-term revenue increases, but there could be long-term pressures on state finances**
  - As proposed, federal tax reform could reduce federal revenues by as much as $1.5 trillion (based on static scoring)
  - Federal debt to GDP is now at 105 percent – significantly above the 50 year average of 40 percent.
  - The full (or partial) repeal of deductions for state and local income and property taxes  increases the after-tax costs of state and local government at a time when federal resources will be constrained.