

The 2017 US tax reform for individuals from a local perspective

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Abstract

The US Tax Cuts and Jobs Act of 2017 reduced marginal tax rates for a wide range of US individuals, especially small business owners. However, marginal tax rates in Hong Kong remain competitive and are still almost always lower for individuals and businesses with similar levels of income. Other aspects of the US individual tax reform, such as the expanded child tax credit, increased exemption for estate and gift taxes, and limited state and local tax deduction are expected to have only minimal local impact.

以本港角度分析美國 2017 年個人稅制改革

摘要

美國的 2017 年減稅與就業法案降低了大部分美國個人（特別是小企業東主）的邊際稅率。不過，香港的邊際稅率仍具競爭力；對大部分收入水平相若的個人和企業而言，香港的邊際稅率還是較低。美國個人稅制改革的其他方面，例如擴大子女稅收抵免、增加遺產稅和贈與稅的豁免額，以及限制州和地方稅的稅務扣減，預計對本港影響有限。

<p>The views and analysis expressed in this article are those of the author and do not necessarily represent the views of the Office of the Government Economist.</p>

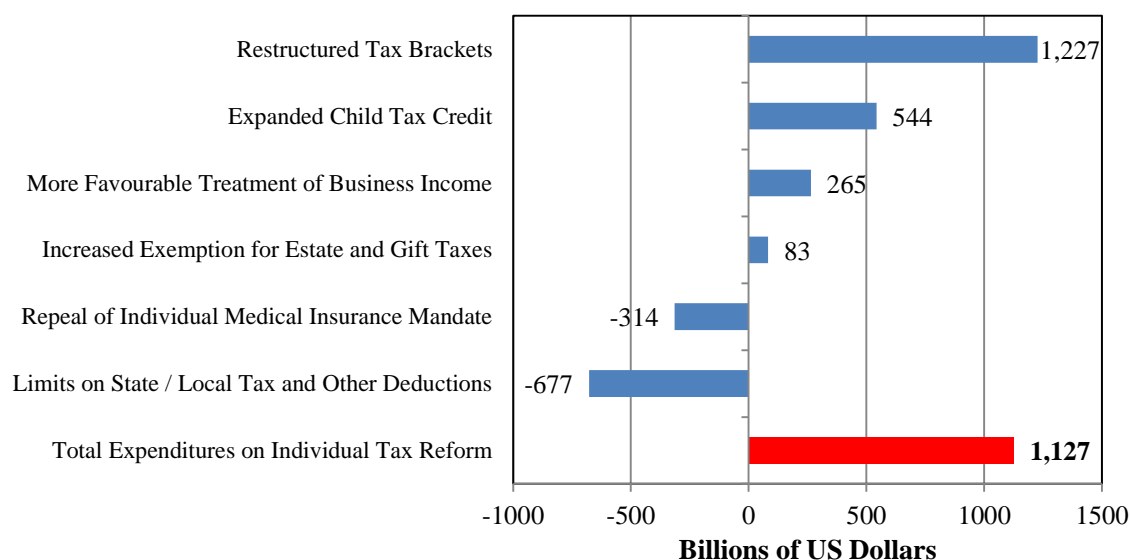
I. INTRODUCTION

1. In December 2017, the US Congress enacted the most comprehensive reform of the US tax code since the 1980s. In addition to replacing the previous top corporate tax rate of 35% with a much lower flat corporate tax rate of 21%, the reform also includes measures to shift the taxation of US businesses toward a territorial system and lower individual tax rates. This article examines the changes to the tax system for individuals in the US and makes relevant observations from Hong Kong's perspective.

II. KEY ASPECTS OF US INDIVIDUAL TAX REFORM

2. The US Tax Cuts and Jobs Act (TCJA) of 2017 is a large and complex piece of legislation, and the Act's provisions for individuals are no exception. Nevertheless, a general idea of their relative importance can be obtained from the Joint Committee on Taxation's official estimates of their effects on government revenue. *Chart 1* displays these estimates, for individuals, with the provisions grouped into broad categories. The first four categories are expected to incur expenditures, while the last two categories are expected to raise revenues.

Chart 1: Estimated Expenditures by the US on Individual Tax Reform, 2018-27



Source: Joint Committee on Taxation, US Congress.

II.1 Individual Tax Reforms Expected to Raise Expenditures

3. As can be seen from *Chart 1*, the largest individual reform—by a considerable margin—is to amend the federal individual tax brackets. This reform involves about US\$1.2 trillion in expenditures over the next decade and includes amendments to the underlying alternative minimum tax (AMT)¹ and amendments to fold personal and dependent exemptions into the standard deduction². Generally, marginal tax rates were lowered by up to 4 percentage points for those earning less than US\$169,500 per year (or US\$339,000 per year for married couples)³, and the top rate was reduced by 2.6 percentage points, from 39.6% to 37.0%. The 2018 statutory tax brackets for single earners before and after the enactment of the TCJA are listed out more fully in *Annex I*.

4. A comparison of Hong Kong’s and the US pre- and post-reform marginal tax rates for individuals with employment income is given in *Chart 2*. In this chart, pre-reform statutory US tax rates are adjusted to take account of the phase-out of exemptions at higher income levels; this implicitly raises the marginal tax rate within the phase-out range. This adjustment is not necessary for post-reform marginal US tax rates because the reform abolished these exemptions entirely. Further, as suggested by an OECD guideline, 6.65 percentage points are added to the pre- and post-reform marginal US tax rates in order to account for the effects of state and local taxes^{4,5}.

¹ The AMT is a parallel tax system designed to impose minimum taxes on those who claim a large number of deductions under the ordinary tax system. Taxpayers are required to calculate their liability under both systems and pay whichever amount is higher.

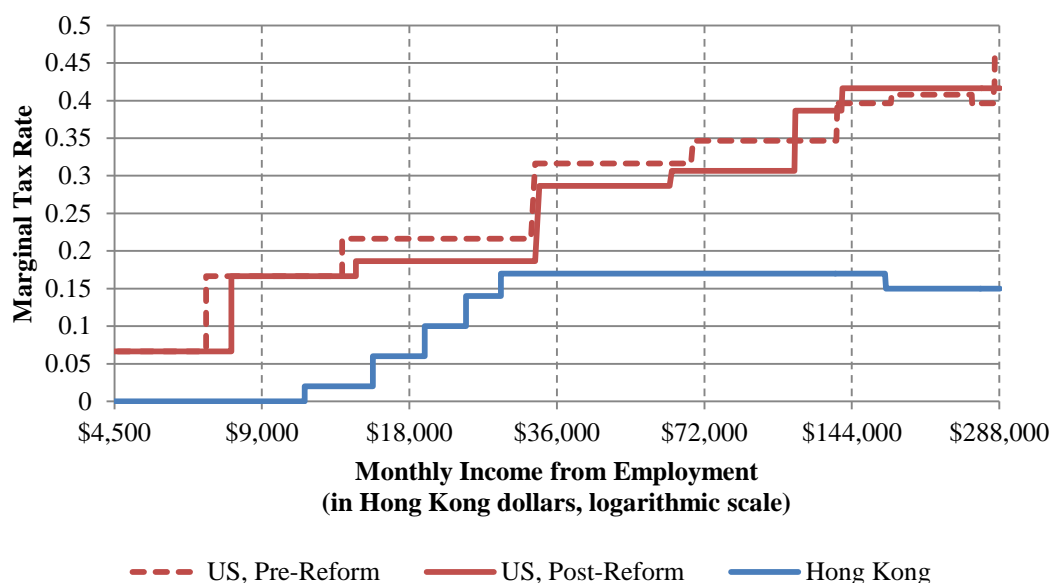
² Under the old tax law, taxpayers could claim one exemption per household member on top of the standard deduction to reduce their taxable income. Under the new law, “exemptions” do not exist; the standard deduction depends on filing status (e.g. “single” or “married filing joint return”; which is similar in concept to Hong Kong’s Basic and Married Person’s Allowances), and additional benefits for families with children are allocated through the child tax credit.

³ Total income before subtracting the new standard deduction of US\$12,000 for individuals and US\$24,000 for married couples.

⁴ OECD, 2017. “Table I.2 - Sub-central personal income tax rates - non-progressive systems.” http://stats.oecd.org/index.aspx?DataSetCode=TABLE_I2

⁵ Payroll taxes are not added to marginal US tax rates because, like Mandatory Provident Fund contributions, they are used to fund Social Security and Medicare benefits later in life.

Chart 2: Marginal Tax Rates for Individual Employees in Hong Kong (2018/19) and the US (2018)⁶



Note: Annual income is converted to monthly income by dividing by 12.
Sources: *Forbes*, the OECD, the Tax Foundation, and the Inland Revenue Department.

5. **Chart 2** shows that, at levels of employment income applicable to most of the labour force, the reform resulted in lower marginal tax rates. There is, however, a group of high income earners in the US (those earning between US\$169,500 to US\$433,200 per year / HK\$110,175 to HK\$281,580 per month)⁷ who face higher marginal tax rates than before. This happens because the post-reform 5th and 6th tax brackets start earlier, pushing these high earners into higher tax brackets than they were in previously. Past this point, however, marginal tax rates continue to be lowered by the reform, and those in the highest tax bracket benefit from a reduced top rate.

6. **Chart 2** also shows that, for the most part, Hong Kong’s marginal tax rates on employment income continue to be much lower than in the US. However, there is a certain range—from HK\$27,667 to HK\$32,955 per month—where Hong Kong’s 17% bracket overlaps with the US 12% bracket (18.65% after adding in state and local

⁶ US, Pre-Reform: Phillips, K. 2017. “IRS Announces 2018 Tax Brackets, Standard Deduction Amounts, And More.” *Forbes*, 19 October. <https://www.forbes.com/sites/kellyphillips/2017/10/19/irs-announces-2018-tax-brackets-standard-deduction-amounts-and-more/>
US, Post-Reform: El-Sibaie, A. 2018. “2018 Tax Brackets.” Tax Foundation, 2 January. <https://taxfoundation.org/2018-tax-brackets/>
Hong Kong: Inland Revenue Department. 2017. “Allowances, Deductions and Tax Rate Table.” <https://www.ird.gov.hk/eng/pdf/pam61e.pdf>

⁷ Excluding a small number of people earning between US\$206,100 to US\$212,000 per year / HK\$133,965 to HK\$137,800 per month who remain in the 5th bracket and see their marginal federal tax rates decline from 33% to 32%.

taxes). Within this range, Hong Kong's and the US's marginal tax rates on employment income are actually very close to one another.

7. The second element of US individual tax reform in *Chart 1* is an expanded Child Tax Credit, which will involve US\$544 billion of additional expenditure. This credit, which the TCJA doubled from US\$1,000 to US\$2,000, is a fixed per-child tax credit for dependent children. In principle, such a credit might conceivably raise the fertility rate. In practice, however, the amount appears too low to have any notable effect, and empirical estimates confirm that the long-term effect of the Child Tax Credit is not statistically different from zero⁸. As such, it is not expected that the expanded Child Tax Credit would have any particular economic impact.

8. The third element of US individual tax reform in *Chart 1*, involving US\$265 billion of additional expenditure, is a 20% deduction for qualified business income (QBI). The idea behind the 20% deduction is that, if a business owner earns US\$100,000, he or she is only taxed for \$80,000 of earnings. This both reduces the marginal tax rate (because each additional dollar only results in 80 cents of taxable earnings) and expands the width of each tax bracket (since the thresholds for higher statutory tax rates are reached more slowly). The QBI deduction was added so that owners of unincorporated businesses would not be “left out” of reforms to the corporate tax rate⁹.

9. Because of the QBI deduction, the US tax reform is especially favourable for individual business owners. This is reflected in *Chart 3*, which compares Hong Kong's tax rates with US pre- and post-reform tax rates for unincorporated business owners. For reference, *Chart 3* also includes the effect of Hong Kong's two-tier Profits Tax, which provides for a tax rate of 7.5% on the first HK\$2 million of profits for unincorporated businesses. The two-tier Profits Tax was enacted by the Legislative Council on 21 March 2018¹⁰. Under the two-tier Profits Tax, the Profits Tax becomes more favourable than personal assessment for individual business owners at an annual income of HK\$425,684 (or a monthly income of HK\$35,474)¹¹.

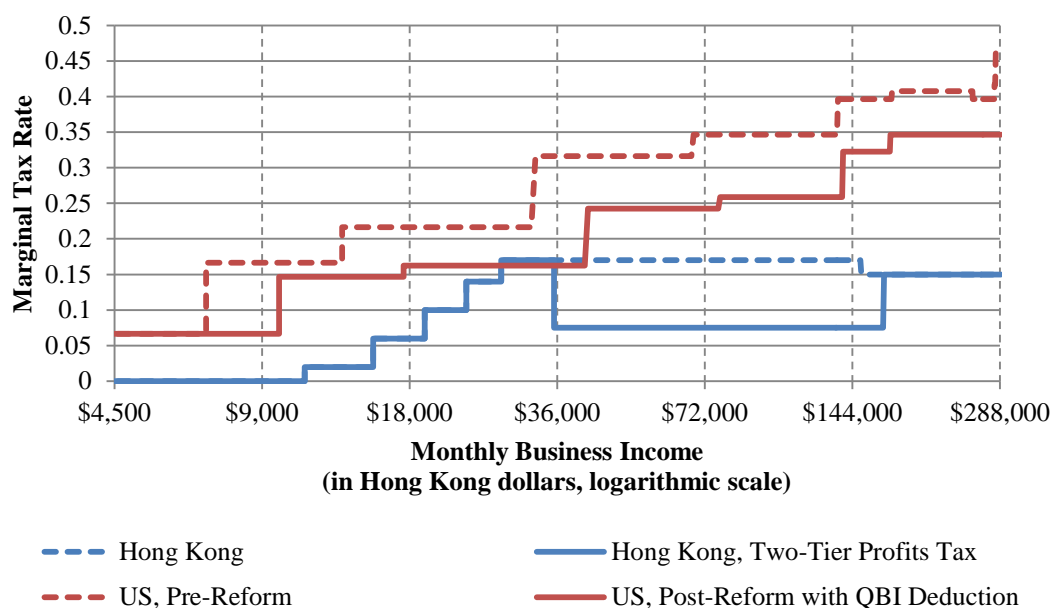
⁸ Mumford, K. and P. Thomas. 2016. “Fertility Response to the Tax Treatment of Children.” Mimeo, Purdue University. https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=NTA2017&paper_id=253

⁹ Nitti, T. 2017. “Tax Geek Tuesday: Making Sense Of The New ‘20% Qualified Business Income Deduction.’” *Forbes*, 26 December. <https://www.forbes.com/sites/anthonymitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/>

¹⁰ Legislative Council. 2018. “Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2017.” <https://www.legco.gov.hk/yr17-18/english/bc/bc03/general/bc03.htm>

¹¹ This is the point at which the average tax rate under personal assessment exceeds 7.5%, assuming that only the basic allowance is claimed.

Chart 3: Marginal Tax Rates for Individual Business Owners in Hong Kong (2018/19) and the US (2018)



Note: Annual income is converted to monthly income by dividing by 12. The post-reform marginal tax rates for the US assume that the QBI deduction is applicable to all individual business income.

Sources: *Forbes*, the OECD, the Tax Foundation, the Inland Revenue Department, and the Legislative Council.

10. From **Chart 3**, it is clear that the first tier of Hong Kong’s two-tier Profits Tax preserves the competitive margin between Hong Kong and US tax rates at monthly business incomes between HK\$35,474 and HK\$166,667. However, for monthly business incomes between HK\$27,667 and HK\$35,474, Hong Kong’s marginal tax rate of 17% is slightly higher than the US marginal tax rate of 16.25% (inclusive of state and local taxes).

11. At higher income levels (US\$169,500 per year / HK\$110,175 per month and higher, for individual business owners who claim the standard deduction), the US QBI deduction phases out for “specified service trades or businesses”¹² and businesses in other areas that pay lower employee wages or are less capital-intensive than others. This results in marginal tax rates higher than those shown in **Chart 3** for affected businesses. The precise formula for the phase-out is very complex, but generally

¹² A “specified service trade or business” is “any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business the principal asset of which is the reputation or skill or one or more of its owners or employees (excluding engineering and architecture), or any business that involves the performance of services that consist [of] investment and investment management trading or dealing in securities, partnership interest, or commodities.” KPMG, 2017. *New Tax Law (H.R. 1) – Initial Observations*, p. 69. <https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/12/tnf-new-tax-law-dec22-2017.pdf>

speaking, the marginal income tax rates can be quite steep (up to 65.38%¹³) for businesses that find themselves within the phase-out range.

12. The fourth element of US individual tax reform in *Chart 1*, expected to involve US\$83 billion of additional expenditure, is a doubling of the exemption amount for estate and gift taxes (from US\$5.6 million to US\$11.2 million in 2018¹⁴). The change is expected to reduce the number of estates in the US subject to the tax from 5500 to 1700 per year, or from 0.2 percent of deaths to less than 0.1 percent of deaths¹⁵. This moves the US system closer to Hong Kong's, which abolished estate taxes with effect from 11 February 2006¹⁶. However, it is worth noting that, even pre-reform, the US estate tax did not capture very many estates and hence the effects of raising the exemption amount are expected to be minimal.

II.2 Individual Tax Reforms Expected to Raise Revenues

13. Apart from expenditure items, *Chart 1* also contains two revenue items. The first of these, a repeal of the requirement for US residents to acquire health insurance, is expected to raise US\$314 billion as the federal government would no longer need to pay associated subsidies¹⁷. Beyond this change, the future shape of the US health care system is unclear, not least because several proposals to more comprehensively

¹³ Since taxable income subject to the QBI deduction only accumulates at 80% of the normal rate, it needs to accumulate at a faster rate over the phase-out range to make up for past deductions. For example, a business owner at the beginning of the phase-out range might have US\$169,500 in income and a QBI deduction of US\$33,900 (US\$169,500 × 20%). Over the next US\$50,000 of income, taxable income increases by \$83,900 (US\$50,000 + US\$33,900 of phased-out deduction), or at 167.8% of the normal rate (US\$83,900/US\$50,000). This reverses the mechanism in para. 8, multiplying the statutory tax rate by 167.8% and accelerating progression through the tax brackets until the phase-out is completed. In the 35% tax bracket, the phase-out imposes a tax rate of 58.73% (35% × 1.678); after adding 6.65% for state and local taxes, the result is a marginal rate of 65.38%.

¹⁴ Ebeling, A. 2017. "IRS Announces 2018 Estate And Gift Tax Limits: \$11.2 Million Per Couple." *Forbes*, 19 October. <https://www.forbes.com/sites/ashleaebeling/2017/10/19/irs-announces-2018-estate-and-gift-tax-limits-11-2-million-per-couple/>

Note: The title of this article refers to what the estate and gift tax limit for 2018 would have been prior to the enactment of the JCTA (US\$5.6 million per individual, or US\$11.2 million per couple). The article includes a one-paragraph December 2017 update to describe the effect of the JCTA (US\$11.2 million per individual, or US\$22.4 million per couple); however, the remainder of the article, including the title, remains as it was published in October 2017.

¹⁵ Gleckman, H. 2017. "Only 1,700 Estates Would Owe Estate Tax in 2018 Under the TCJA." Tax Policy Center, 6 December. <http://www.taxpolicycenter.org/taxvox/only-1700-estates-would-owe-estate-tax-2018-under-tcja>

¹⁶ HKSAR Government, 2005. "LegCo passes the Revenue (Abolition of Estate Duty) Bill 2005." <http://www.info.gov.hk/gia/general/200511/02/P200511020261.htm>

¹⁷ Johnson, Carolyn Y. 2017. "Why repealing Obamacare's individual mandate is so crucial for tax reform." *Washington Post*, 14 November. <https://www.washingtonpost.com/news/wonk/wp/2017/11/14/why-repealing-obamacares-individual-mandate-is-so-crucial-for-tax-reform/>

modify the existing system have failed in Congress¹⁸. As such, it is too early to say what the final implications of this change will be.

14. The second revenue item in *Chart 1* is the removal or limitation of several “itemized” deductions which had previously been claimable by individuals not opting for the standard deduction. Of these changes, which in total are expected to raise US\$677 billion in revenue, the most significant by far is a new upper limit on the deductibility of state and local taxes (US\$10,000). This change, by itself, provides US\$644 billion of additional revenue¹⁹, or 95% of the total. Its main effect will be to reduce cross-subsidization of residents of high-tax states by residents of low-tax states; it is hoped that, by doing so, the economic efficiency of state and local government expenditures will improve²⁰.

III. CONCLUDING REMARKS

15. The US tax reform is, in general, positive for US individuals because many will see their taxes at least modestly reduced in the years ahead. A few will even see marginal tax rates similar to Hong Kong’s, though their average tax rates will remain considerably higher. This is especially true for smaller US business owners, though the phase-out of the QBI deduction will be difficult to manage for those with higher levels of income.

16. In general, Hong Kong’s marginal tax rates continue to be significantly lower than US marginal tax rates even after the US tax reform. However, there is some evidence that US consumers are planning on spending more on household items, computer items, and jewellery in response to the legislation²¹. Since the US is one of Hong Kong’s trading partners, this may create opportunities at a later stage for local firms that trade in the relevant goods and services.

¹⁸ Amadeo, K. 2018. “Donald Trump on Health Care.” *The Balance*, 11 January. <https://www.thebalance.com/how-could-trump-change-health-care-in-america-4111422>

¹⁹ Tax Policy Center. 2017. “T17-0339 - Repeal \$10,000 Limit on Deductible State and Local Taxes.” <http://www.taxpolicycenter.org/model-estimates/repeal-ten-thousand-dollar-limit-deductible-state-and-local-taxes-dec-2017/t17-0339>

²⁰ Greszler, R., and K. Dayaratna. 2015. “Time to End the Federal Subsidy for High-Tax States.” Heritage Foundation, 26 March. <https://www.heritage.org/taxes/report/time-end-the-federal-subsidy-high-tax-states>

²¹ Drenik, D. 2018. “Tax Cuts And Jobs Act Begins To Have Positive Impact On Spending Intentions.” *Forbes*, 19 March. <https://www.forbes.com/sites/forbesinsights/2018/03/19/tax-cuts-and-jobs-act-begins-to-have-positive-impact-on-spending-intentions/>

**2018 US Statutory Federal Tax Brackets for
Single Earners Before and After Tax Reform**

Pre-Reform		Post-Reform	
Range (in US\$)	Tax Rate	Range (in US\$)	Tax Rate
0 to 9,525	10%	0 to 9,525	10%
9,526 to 38,700	15%	9,526 to 38,700	12%
38,701 to 93,700	25%	38,701 to 82,500	22%
93,701 to 195,450	28%	82,501 to 157,500	24%
195,451 to 424,950	33%	157,501 to 200,000	32%
424,951 to 426,700	35%	200,001 to 500,000	35%
426,701 and higher	39.6%	500,001 and higher	37%

Note: The tax brackets are for taxable income after subtracting any applicable exemptions and deductions.

Sources: *Forbes* and the Tax Foundation.