Proactive Investment Management & Financial Planning

Global Perspectives, January 2018: Assessing the Tax Cut and Jobs Act of 2017

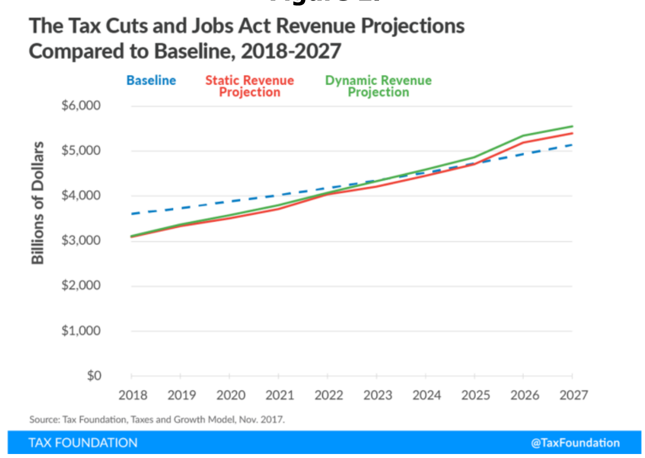
In December 2017, the "Tax Cuts and Jobs Act" (TCJA) was passed by Congress and signed into law by President Trump. The TCJA is the most significant reform of the U.S. income-tax system since 1986, and it is widely expected to have a profound impact on the economy and financial markets. Indeed, those impacts are already becoming apparent. In this article, we aim to provide a short, concise overview of the TCJA and explore its likely impact on the economy, the financial markets, and our investment strategy.

Basic Parameters

Covering fully 185 pages, the TCJA contains a vast number of provisions and touches a wide swath of the U.S. economy, from business investment to oil sales from the Strategic Petroleum Reserve. Generally, it aims to cut income taxes for corporations, small businesses, and individuals. The Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT) officially estimated in early January that the tax cuts in the TCJA will reduce federal revenues and widen the federal budget deficit by $1.5 trillion from 2018 to 2027, compared with previous expectations. Taking into account the added interest costs associated with more government borrowing, they estimated the deficit will widen by $1.8 trillion over the decade.

On a more positive note, authoritative analysts predict the TCJA will also boost economic growth. For example, the International Monetary Fund (IMF) in late January said it now expects U.S. gross domestic product (GDP) to expand by 2.7% in 2018 and 2.5% in 2019, versus its previous forecasts of 2.3% and 1.9%, respectively. The upward revisions mostly reflect the TCJA's cut in corporate income taxes, which the IMF expects to boost investment. The IMF also thinks stronger U.S. activity will spark faster growth in other countries. In fact, it now forecasts global economic growth of 3.9% in both 2018 and 2019, with the TCJA accounting for about half of the upward revision from the previous forecast of 3.7%. Such a rise in economic growth should lift corporate and individual incomes, which we think is a clear positive. The rise in income would probably also produce additional tax revenue that could offset some of the gross cut in taxes. The Tax Policy Center estimates this "positive macroeconomic feedback" will amount to about $186 billion from 2018 to 2027, while the Tax Foundation and other organizations expect the figure to be even greater (see Figure 1). We expect a ***net*** decrease of perhaps $1.2 trillion in federal revenues over the decade.

Figure 1.



Corporate Taxation

As the TCJA made its way through Congress, the focus always seemed to be on corporate taxes. Several different reforms were discussed, but the provisions ultimately adopted primarily focused on cutting corporate tax rates, eliminating taxes on corporations' foreign earnings, encouraging more investment, and discouraging high levels of corporate borrowing.

Corporate Tax Rates. As with individual income taxes, U.S. corporate income-tax rates are "progressive," i.e., the applicable tax rate increases as taxable income goes up. Under TCJA, the top corporate rate has been cut to 21.0%, bringing it in line with, or even below, the top rate in most other advanced, highly competitive economies. For comparison, the top corporate rate under previous law was 35.0%, which kicked in at a taxable income of just $15 million. The corporate rate cut under TCJA therefore looks quite significant. Nevertheless, it is important to remember that even before TCJA, most large U.S. companies were able to utilize a range of special deductions, credits, and other provisions to bring their tax burden closer to international norms. In some industries, such as manufacturing, the typical reduction from the nominal top rate was quite large, in part because such firms often have substantial operations in low-tax locations abroad. In other industries, such as retailing, there were fewer opportunities to reduce taxes. We believe those industries could see big increases in their after-tax profits under TCJA.

Foreign Earnings. Under TCJA, U.S. companies will no longer be required to pay taxes on their foreign earnings. In contrast, the burdensome system prior to TCJA applied U.S. tax rates to all foreign earnings, although it also offered a deferral of those taxes on any earnings not yet "repatriated" (brought back) to the United States, and it provided a credit for any foreign income taxes paid. Since that system discouraged the repatriation of foreign earnings, U.S. firms now hold hundreds of billions of dollars of past profits in their foreign affiliates. To make up for some of the tax revenue that would be lost by not taxing foreign earnings (and to encourage some of that foreign money to be injected into the U.S. economy), the TCJA includes two important provisions:

- ***One-Time Tax on Foreign Earnings.*** The TCJA imposes a one-time tax of 15.5% on any foreign earnings not previously repatriated (8.0% on illiquid assets). Since that tax rate may be lower than the top rate at home and abroad, the provision is expected to encourage firms to move billions of dollars of foreign funds back to the United States.

- ***Special Provisions for Intangible Assets.*** Prior to the TCJA, multinational companies would often house their "intangible" assets (such as patents) in a low-tax jurisdiction abroad. The income from those assets (such as royalty payments) would therefore be taxed at low rates, reducing the company's overall tax bill. In order to discourage that maneuver, the TCJA imposes a new tax on "Global Intangible Low-Tax Interest" (GITLI). It also provides for a low 13.125% tax rate on foreign-derived income from intangible assets held in the United States.

Investment and Interest Deductions. Under TCJA, companies can immediately deduct from their taxable income 100% of qualifying capital investment, rather than depreciating it over many years as under the previous law. Since that would cut companies' taxes, we think it will provide a further incentive to invest, on top of the incentive from lower tax rates. TCJA also generally allows interest to be deducted only up to 30% of a measure of operating earnings, which should discourage the use of debt.

Alternative Minimum Tax. The TCJA eliminates the corporate Alternative Minimum Tax (AMT). However, in order to discourage certain maneuvers that would allow multinational companies to pay little or no tax, the law also creates and applies a new "Base Erosion and Anti-Abuse Tax" (BEAT). The BEAT tax is an additional levy on companies that pay a lot of interest, royalties, or service fees to foreign affiliates.

Pass-Through Business Taxation

The TCJA also aims to cut taxes for sole proprietorships, partnerships, LLCs, and other small firms that are not organized as corporations. The business income for these "pass through" firms is reported on the owners' individual tax return and taxed at individual tax rates. Without any special provision, this business income could be subject to a much higher tax rate than corporate income. To partially mitigate that problem, the TCJA allows business owners to exclude 20% of such commercial income from their individual tax return through 2025. The 20% exclusion applies to income up to $157,500 for a single taxpayer and $350,000 for a married couple filing jointly, although it phases out above those limits. For the income that it applies to, the exclusion effectively cuts the top tax rate to 29.6%.

Notably, however, there is no exclusion above the stated dollar limits for business owners who earn certain "personal service" income, such as accountants and physicians. The idea is apparently that those professionals' business income is so similar to wage income that it shouldn't enjoy the benefit of being treated as commercial.

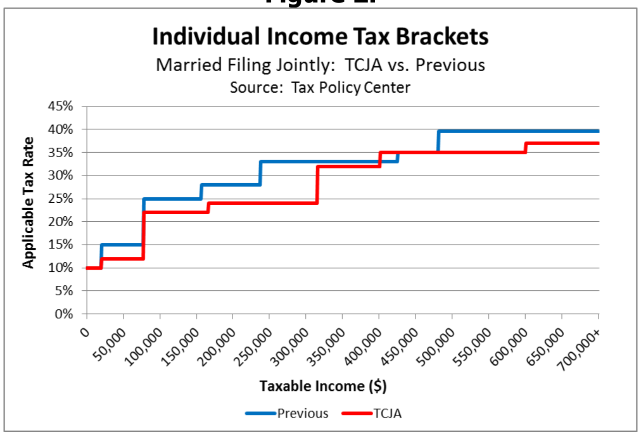
Individual Taxation

Even though the main focus of TCJA is to permanently cut taxes on corporate income and temporarily lower taxes for pass-through businesses, the law also provides for a wide range of temporary changes to the individual income-tax system. Generally, these provisions are in place only through 2025. Unless Congress takes steps to extend them, the provisions would then expire and previous law would apply again.

Individual Tax Rates. The TCJA has seven individual tax brackets, just as the previous law did, but it temporarily cuts the tax rate for most of those brackets through 2025. The only brackets without a rate cut are the 10% and 35% brackets. To illustrate the changes, Figure 2 (next page) shows the old and new tax rates for a married couple filing jointly. For that class of taxpayers, the biggest rate reduction occurs for taxable income between $237,950 and $315,000. For couples whose income is in that range, the top tax rate falls to

24% from 33% previously. In contrast, there is no rate reduction for couples whose income is less than $19,050, or for those whose income is between $424,950 and $480,000. The tax rate actually rises for those unlucky couples whose income is only slightly above $400,000.

Figure 2.



Exemptions, Deductions, Credits. Even though the cut in tax rates will be highly appreciated by many individuals, we think the biggest changes are actually in the realm of exemptions, deductions, and credits. As with the cut in tax rates, these changes are only in place through 2025, after which the previous provisions would apply. We examine some of the main changes below:

- ***Personal Exemption Eliminated.*** The TCJA eliminates the personal exemption, which had previously reduced taxable income by $4,150 for each taxpayer and his or her dependents. For example, a four-person household consisting of a husband, a wife, and two children would previously have 4 x $4,150 = $16,600 of their income exempt from tax. Under the TCJA, the personal exemption would no longer exist, and that income would now be subject to tax.

- ***Standard Deduction Raised.*** Fortunately, the removal of the personal exemption would be at least partially offset by a provision that would nearly double the standard deduction. For a single taxpayer, the standard deduction is increased from $6,500 under previous law to $12,000 under the TCJA. For a married couple filing jointly, the standard deduction is raised from $13,000 to $24,000. Generally, it is more advantageous for a taxpayer to take the greater of the standard deduction or the total of itemized deductions. Therefore, the rise in the standard deduction under the TCJA is expected to dramatically cut the number of taxpayers who itemize.

- ***Certain Itemized Deductions Limited.*** The TCJA temporarily suspends the limit on total itemized deductions, but for those who might still be tempted to itemize, the law imposes several new hurdles. For example, the law limits the deduction for state/local income and sales taxes to just $5,000 for a single payer and $10,000 for a couple filing jointly. It also allows a mortgage interest deduction only for acquisition debt (no home equity loans), up to $750,000 on one principal and one other residence. These provisions are not only expected to further discourage itemizing, but they are likely to have a pronounced negative impact on those living in relatively high-tax states with expensive housing markets.

- ***Child Tax Credit Increased.*** In another big change that will affect many taxpayers, the TCJA raises the Child Tax Credit to $2,000 per qualifying child under the age of 17, compared with a credit of $1,000 previously. It also provides a new $500 credit for other qualifying dependents. Under TCJA, the credit also begins to phase out at much higher incomes than before. For example, for married couples filing jointly, it would begin to phase out only when taxable income exceeds $400,000.

AMT and Other Provisions. Finally, among the other major changes, the TCJA raises the exemption amount for the individual AMT. In our view, that change is likely to significantly reduce the odds that an individual will have to worry about that levy, though it won't entirely end it. For investors, the law makes no change to the system of taxing capital gains, interest, or dividends.

Implications and Conclusion

As mentioned above, the TCJA is the most significant, far-reaching, complex set of tax changes in more than three decades. Many of the changes will require the Internal Revenue Service to develop detailed new rules and guidance, and that process is only now getting under way. It is therefore still too early to fully and accurately understand how the law will affect the economy, the financial markets, and various types of taxpayers. Nevertheless, we think the TCJA is likely to provide a strong jolt to the economy and markets in the near term, though at the risk of higher inflation, rising interest rates, and bigger federal budget deficits over time.

Business Sector. In the business sector, we think the permanent cut in tax rates, the temporary expensing of capital investment, and the modest simplification of rules will boost profitability and cash flows for at least several years, while making it more attractive for multinational firms to invest in the United States than abroad. Many firms have already recognized big accounting losses because of changes such as the one-time tax on unrepatriated foreign earnings and the decreased value of previous tax losses that can be carried forward to future years (such "carry forwards" are less valuable when tax rates are lower). However, those near-term charges should be more than offset by the positive changes in the law. Media reports already suggest firms will put their increased cash flow to work by boosting their U.S. investment, giving their employees raises or bonuses, hiking dividends, buying back stock, or reducing debt. Those changes help explain why so many observers expect the law to jolt the economy. They also explain why the long-standing bull market in stocks has intensified in the weeks since the TCJA was signed into law, even though the new stimulus will likely boost inflation and could prompt the Federal Reserve to start raising interest rates faster.

Consumer Sector. We think a lot of the TCJA's impact on consumers will come from companies hiring more, boosting wage rates, and granting one-time bonuses. The changes in the individual income tax will also be positive, but as with companies, some taxpayers will be more affected than others. Some will actually be hurt. To illustrate the potential impacts for two types of taxpayer, Table 1 traces the changes in a very simplified way for a single adult with a total income of $100,000 and $6,000 in itemizable deductions, and for a family of four with $100,000 in income and itemizable deductions of $18,000. For the single taxpayer with no dependents, losing the personal exemption of $4,150 is more than offset by the $5,500 increase in his or her standard deduction. That taxpayer might enjoy both lower taxable income and lower tax rates, resulting in a big tax cut (at least through 2025). For the married couple with two children, losing their total personal exemption of $16,600 is only partially offset by the $11,000 increase in their standard deduction. In this example, their taxable income would be higher under the TCJA, though the lower tax rates would give them a slight cut in their tax before credits. The main benefit to them would be the increased Child Tax Credit of $2,000. In sum, the analysis shows that the impact of TCJA will vary greatly based on the individual taxpayer's income, family situation, housing debt, and other factors, though we still believe the law will be positive for most individuals.

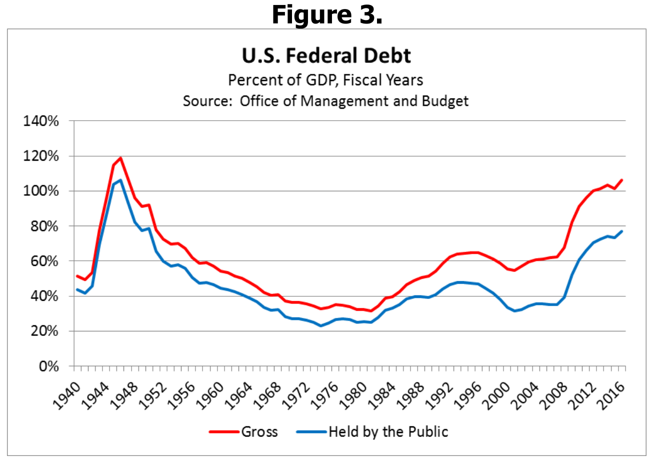
Government Sector. As discussed above, the TCJA is expected to reduce total government revenues by about $1.2 trillion over the next decade. Even with the expected boost to near-term economic growth, the revenue shortfall is likely to be especially sharp in the next few years, just as population aging starts to seriously boost Social Security and Medicare outlays. We believe the federal budget deficit will therefore become significantly wider than previously expected. In other words, the TCJA threatens to boost the ratio of federal debt to GDP, which is already at its highest level since World War II (see Figure 3). That raises the risk of a debt crisis sometime in the future.

Table 1.

Stylized Example of Taxes: TCJA Vs. Previous Law

Adults in Household	1		2	
Dependent Children	0		2	
Itemizable Deductions	$6,000		$18,000	
	Previous	**TCJA**	**Previous**	**TCJA**
Total Income	100,000	100,000	100,000	100,000
Less Personal Exemption	(4,150)	0	(16,600)	0
Less Deductions	(6,500)	(12,000)	(18,000)	(24,000)
Taxable Income	89,350	88,000	65,400	76,000
Tax Before Credits	13,645	11,239	8,858	8,739
Less Child Tax Credit	0	0	(2,000)	(4,000)
Total Tax	13,645	11,239	6,858	4,739
Tax / Total Income	*13.65%*	*11.24%*	*6.86%*	*4.74%*

Figure 3.



Financial Markets and Investment Strategy. Finally, we believe the positive near-term implications discussed above will provide an additional boost to corporate profits and engender increased optimism about the future. That is already pushing stocks upward, so we consider it another reason to maintain our current over-weight positions in equities (in our strategies that include them). In contrast, the TCJA has added to the market's current negative view on bonds, so we continue to modestly under-weight them (in our strategies that include fixed income). As always, we stand ready to adjust our strategy as we see how things develop.

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