ON OUR MINDS

Taking Care of Business

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Congress has an ambitious agenda of important legislation to consider before year-end, with tax reform the top item on the list. President Trump and the so-called Big Six[1] recently unveiled their "Unified Framework for Fixing Our Broken Tax Code," which they hope Congress will transform into a bill to be placed on the President's desk for signature later this year.

Can they do it? The framework is deceptively simple, a nine-page outline of principles and key policy elements that papers over the enormously complex task of implementation. Congress faces an arduous challenge in converting this outline into detailed and comprehensive tax reform. Even against steep odds, it's worth examining the framework to understand its principal elements and its market implications.

Business Taxes

The framework is especially kind to corporate America, embodying an industrial policy that mostly makes good sense. The statutory corporate income tax rate would fall from 35% to 20%, and the global taxation of corporate income would be replaced with a territorial system that taxes only income earned in the United States. These two changes would greatly reduce the incentive to shelter profits overseas. The framework also encourages lawmakers to develop a path to repatriation of prior corporate earnings currently held abroad. Finally, retention of the R&D tax credit and complete expensing of capital investments (over the first five years of the plan) would encourage additional investment in the United States. These are all smart proposals.

Even so, not all of corporate America would benefit if the framework is implemented as proposed. In particular, the framework eliminates the tax deductibility of interest expense, reasoning correctly that tax policy should not drive capital structure. For companies that rely on debt financing – private equity firms and asset-intensive industries (telecom, utilities, and heavy manufacturers, among others) – this proposal could result in higher financing costs.

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[1] The Big Six consists of two people each from the White House, the Senate, and the House of Representatives. The Trump administration delegates are Treasury Secretary Steven Mnuchin and National Economic Council chief Gary Cohn. The Senate leaders are Majority Leader Mitch McConnell and Finance Committee Chair Orrin Hatch. The lower chamber is personified by Speaker Paul Ryan and Ways and Means Committee Chair Kevin Brady.

Personal Taxes

Despite the rush to judgment by many interested parties, it is difficult to assess the potential impact of the Republican plan on most individuals and families; different families in the same tax bracket may see very different outcomes, depending on their unique circumstances. What is clear, though, is that in general the wealthiest Americans will benefit handsomely, while the prospective gains for the majority of middle-class Americans would be much more limited. Indeed, many people might ultimately wind up paying higher taxes, depending on how the details of the framework are resolved. Chart 1 shows the proposal's average impact on after-tax income for each quintile of American households:

Chart 1: Effect of GOP Proposed Tax Cut				
Income Group	Income Range ($000, approx.)	Percent Receiving Tax Cut	Average Tax Cut	Average Change in After-Tax Income
Bottom 80%				
Lowest 20%	Below $25K	71%	$60	+0.5%
Second 20%	$25K – $48K	88%	$290	+0.9%
Middle 20%	$48K – $86K	85%	$660	+1.2%
Fourth 20%	$86K – $149K	79%	$1,110	+1.2%
Top 20%				
80% to 90%	$149K – $217K	67%	$1,140	+0.8%
90% to 95%	$217K – $308K	60%	$1,500	+0.7%
Top 5%	$308K – $733K	74%	$7,620	+2.3%
Top 1%	Above $733K	89%	$129,030	+8.5%
Top 0.1%	Above $3,439K	98%	$722,510	+10.2%

Source: Tax Policy Center

The proposal aims to fold the seven current tax brackets into three or four that would be "at least as progressive" but with a lower overall tax burden. The bigger change in the proposal is the doubling of the standard deduction, tied to the elimination of the $4,050 personal exemption and the removal of the deductibility of state and local tax payments. By doubling the standard deduction to $24,000 for married couples filing jointly, the proposal essentially creates a "zero-tax" bracket for the poorest families.

For middle-class and more affluent families, the higher standard deduction could be a real problem. Far fewer taxpayers would want to itemize deductions when they can no longer include state and local taxes and when the threshold is so much higher. This means that the value of other tax-driven incentives – like having a mortgage or donating to charity – would effectively disappear for many families; in addition, it would become much more difficult to deduct health care costs. For these reasons, the Tax Policy Center analysis concluded that as many as 40% of households in the top 20% of incomes would actually pay *more* tax under the new plan.

Affluent Massachusetts taxpayers would especially feel the pain of these interrelated effects, because the Commonwealth has high real estate prices (i.e. high mortgage payments) and high state and municipal tax rates. Homeowners with several children and incomes between $150,000 and $300,000 would likely be the biggest net losers under the Trump proposal – and this is a description that fits many residents of Massachusetts.

For the top 10% and especially for the top 1% of families, however, the Trump tax plan has many generous gifts, most notably the elimination of the Alternative Minimum Tax, the Generation Skipping Tax, and the estate tax. These factors are largely responsible for the non-partisan Tax Policy Center's conclusion that the top 0.1% of earners will see an average 10% gain in their after-tax incomes.

When Business Is Also Personal

But that's not all! The top 10% of earners gain even more because – separate and apart from their personal incomes – they also own a disproportionate share of financial assets. Corporations are nothing more than groups of people who voluntarily share their capital in hopes of earning a better return than they could individually. In this regard, the tax proposal is especially kind to the *owners* of corporate America – mainly stock market investors. The proposed business tax changes would likely cause American businesses to repatriate capital earned abroad, to invest more money in domestic production, and to return more capital to shareholders in the form of dividends and stock buybacks. All of those changes would likely send stock prices higher, giving a windfall to the wealthiest investors but not to taxpayers who lack the ability to invest.[2]

The beneficence to asset owners goes even further: Nowhere in the framework do the authors recommend any changes to the favorable tax treatment of dividends and long-term capital gains; the authors could easily have incorporated higher tax rates on investment profits as a way of paying for some of the tax cuts to wealthy individuals.

Further obscuring the distinction between business and personal taxes, the proposal also incorporates a flat 25% tax on income earned by pass-through entities (such as Subchapter S companies, proprietorships, partnerships, LLPs, LLCs, and the like). Although the document recognizes that the tax-writing committees will have to be careful to avoid abuse, this idea could mean that many salaried workers would save a bundle if they simply became contractors rather than employees.[3]

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[2] Another way in which the tax proposal may widen the gulf between the "haves" and "have-nots" (investors and non-investors) is that it aims to encourage further development of Roth-type savings plans that would use earnings that have already been taxed; yet paying taxes before investing in retirement plans (rather than paying them many years into the future when money is withdrawn) may create insuperable barriers to savings for many families with limited current cash flows.

[3] The Canadian band Bachman Turner Overdrive long ago recognized America's unparalleled skill in creative use of the tax code. If the section on pass-through entities becomes law, many newly independent contractors may start humming the song that gave this commentary its title: "It's the tax that we avoid, 'cause we're all self-employed." Like the tax proposal, the song focuses on "taking care of business every day … every way."

Outlook

Tax reform is quite possibly the most complex and vigorously debated policy topic in Washington. Every American and every interest group has something to gain or lose; the stakes are high. For tax reform to succeed, it will probably need bipartisan support. Yet Democrats in Congress are already opposed to large portions of the GOP proposal, especially regarding personal taxes. They are also embittered by the President's recent about-face regarding immigration (in which he reneged on his apparent commitment to submit legislation renewing DACA without requiring a southern border fence in return). Lobbyists representing non-profit institutions, churches, and states and cities will also be vocal in their opposition.

A second hurdle is the cost. The Tax Policy Center analysis pegged the ten-year cost of this proposal at $2.4 trillion, a number that the Trump administration disputes. The White House argues that the tax cuts would spur faster economic growth and therefore higher tax revenues in the future, and that the actual cost might be closer to $1.5 trillion. This supply-side logic has been tried before, and in every previous instance the evidence of "trickle down" benefits has failed to appear. When the most affluent Americans have been given tax gifts in the past, they haven't invested or created new jobs; they have simply gotten richer.

Whether any bill is passed, and whether such a bill bears any meaningful resemblance to the current proposal, is unknowable today. Stock market investors, however, are beginning to think that it is possible. Shares of small-cap stocks (which generally have higher effective tax rates) surged immediately after President Trump's election, then lagged for most of this year; both moves can be directly attributed to rising and then falling expectations of tax reform. In the last few weeks, small-cap stocks have once again sped ahead, suggesting that investors now do anticipate a favorable conclusion to this process. If the framework fails, as health care reform did before it, stocks may take a short-term tumble.

Can it be done? Can Congress enact tax reform? Good luck! With a hostile minority party, a majority party riven by disparate interests, a fierce horde of lobbyists swarming the Capitol, an expensive price tag, and a very short time window, the tax proposal has little hope of becoming law this year. But it might still become the foundation of an active debate next year; the landmark 1986 tax reform was enacted in a midterm election year, after all. On the other hand, if you think the health care debate was a fiasco, tax reform could be worse: It's possible that you ain't seen nothing yet.