Tax Reform Insights and Implications
February 2018

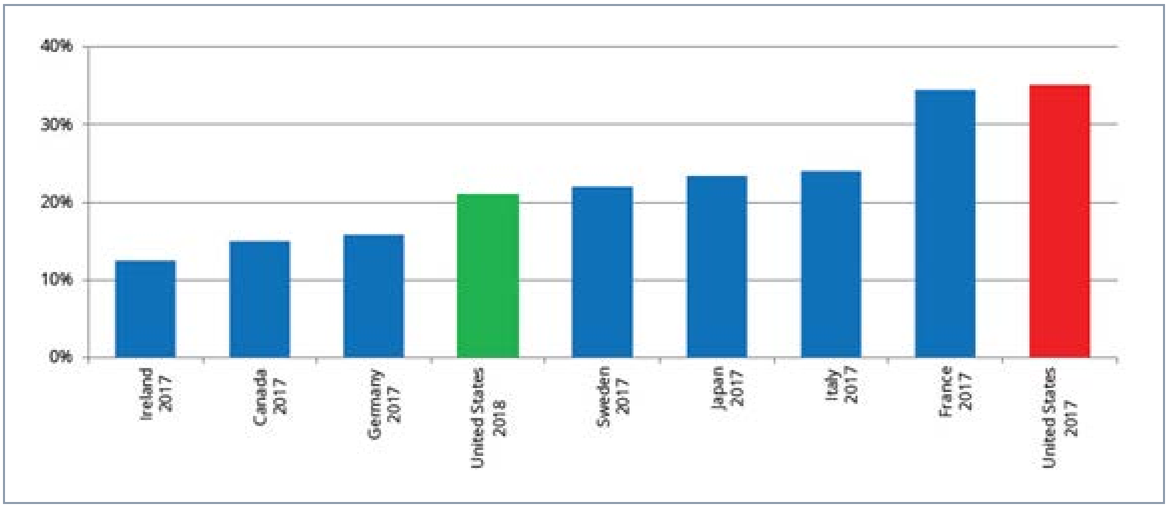
The most significant change to the U.S. tax code in over 30 years became official when the Tax Cuts and Jobs Act was signed into law on December 22, 2017. This substantial tax overall includes many changes to corporate and individual tax rates and deductions, which will likely make a meaningful impact to the U.S. economy and financial markets over the short-term and long-term. While investors had been anticipating some degree of tax reform to occur since the outcome of the U.S. presidential election in November 2016, progress on formulating and passing tax reform into law was sluggish until late 2017. Even after tax reform discussions began in earnest in the fourth quarter of 2017, the ability to reconcile the House and Senate versions, as well as attracting enough support to pass the final bill, was relatively uncertain until the final weeks of 2017.

Tax Cuts and Jobs Act Highlights & Observations

As mentioned above, the Tax Cuts & Jobs Act has a far reaching impact on business and individuals. While many of the changes to the corporate tax code are permanent, the majority of the tax changes in the new law for individuals are set to expire in 2025. Several of the most material tax reform changes impacting businesses and individuals are listed below.

Businesses

- Perhaps the most significant change is a permanent reduction in the U.S. statutory corporate tax rate from 35% to 21%. This reduction makes the U.S. statutory tax rate more competitive when compared to other Organization for Economic Cooperation and Development (OECD) nations.



Source: OECD

- While the previous U.S. statutory tax rate was among the highest of the OECD countries, the effective tax rate for many U.S.-based corporations, which is adjusted for deductions, tax breaks and other loopholes, was actually lower (roughly 27.1% according to Congressional Research Services). Nevertheless, the new corporate tax rate will be beneficial for the majority of U.S.-domiciled companies, and companies with a higher percentage of domestic revenues and operations will generally see the largest benefit. Further, this lower rate could entice many U.S-based companies to eventually bring operations in lower-tax foreign countries back to the U.S.

- The Tax Cuts and Jobs Act moves the U.S. from worldwide system of taxation to a territorial system. In a worldwide system, a U.S.-domiciled business must pay U.S. corporate income tax on all income, regardless of whether it is earned in the U.S. or abroad, subject to a foreign tax credit that adjusts for the foreign tax already paid in the country in which the profits were earned. This tax is paid when foreign earnings are brought back to the U.S. In a territorial tax system, the U.S. will only tax income earned in the U.S., with most or all foreign income exempted from U.S. taxes. This change will help level the playing field for U.S.-based companies since the U.S. was the only G-7 country that utilized a worldwide tax system prior to 2018.

- The repatriation tax rate on deferred foreign profits held by U.S. corporations in countries outside of the U.S. has been reduced from 35% to 15.5% on liquid assets (i.e. earnings held as cash or cash equivalents), and to 8% on earnings derived from illiquid assets. This significant reduction to repatriation tax rates provides a reasonable incentive for companies to bring cash held overseas back to the U.S. A 2015 report by the nonpartisan Joint Committee on Taxation estimated that $2.6 trillion in earnings generated by U.S.-based companies was held in foreign countries. How much of this ultimately gets repatriated remains to be seen, but several companies (e.g. Apple) have already announced plans to bring back hundreds of billions in overseas cash to the U.S.

- The new law allows for 100% upfront expensing of capital investments ("bonus deprecation") for the next five years, which allows companies to reduce their tax burden by immediately writing off the cost of new and used property, plant and equipment. Capital-intensive companies are positioned to benefit the most from this bonus depreciation. In addition, this change could lead to higher levels of capital expenditures over the next several years. Bonus depreciation is scheduled to be reduced 20 percentage points each year beginning in 2023 until is it completely eliminated in 2027.

- The deductibility of net interest expense is now limited to 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) through 2021, and 30% of earnings before interest and taxes (EBIT) thereafter. This limitation could negatively impact companies with high leverage.

Overall, these changes will lead to greater levels of excess capital for many corporations. Examples of how this capital could be deployed includes capital expenditures, share repurchases, dividends (increases and initiations), balance sheet optimization, workforce investments (new hires, wage hikes, one-time bonuses, 401k match increases), merger and acquisition activity, and increased research & development budgets.

<u>Individuals</u>

- The seven tax bracket structure for ordinary income earned by individuals will remain in place, but the income ranges for each bracket, and, in some cases, tax rates for each bracket, have been modified (e.g. the highest marginal tax rate has been lowered from 39.6% to 37%).

Old Vs. New Tax Brackets For Single Filers

Old brackets		New brackets	
Taxable income	Tax rate	Taxable income	Tax rate
$0-$9,525	10%	$0-$9,525	10%
$9,526-$38,700	15%	$9,526-$38,700	12%
$38,701-$93,700	25%	$38,701-$82,500	22%
$93,701-$195,450	28%	$82,501-$157,500	24%
$195,451-$424,950	33%	$157,501-$200,000	32%
$424,951-$426,700	35%	$200,001-$500,000	35%
$426,701+	39.6%	$500,001+	37%

Sources: docs.house.gov, taxfoundation.org

Old Vs. New Tax Brackets For Marrieds Filing Jointly

Old brackets		New brackets	
Taxable income	Tax rate	Taxable income	Tax rate
$0-$19,050	10%	$0-$19,050	10%
$19,051-$77,400	15%	$19,051-$77,400	12%
$77,401-$156,150	25%	$77,401-$165,000	22%
$156,151-$237,950	28%	$165,001-$315,000	24%
$237,951-$424,950	33%	$315,001-$400,000	32%
$424,951-$480,050	35%	$400,001-$600,000	35%
$480,051+	39.6%	$600,001+	37%

Sources: docs.house.gov, taxfoundation.org

- The standard deduction for single filers has been increased from $6,350 to $12,000, and the standard deduction for married and joint filers has been increased from $12,700 to $24,000 (indexed annually). This change will lead to a smaller tax burden for many tax payers. In addition, the tax filing process will become less complicated as more tax payers will simply take the standard deduction as opposed to itemizing deductions.

- The home mortgage interest deduction has been limited to interest on the first $750,000 of new loans, down from a previous cap of $1,000,000. This change could marginally reduce the demand for housing in higher-priced markets where a higher percentage of mortgages exceed this new cap. In addition, the mortgage interest deduction benefit will become less important as a result of increase in the standard deduction (i.e. for many, the standard deduction will represent a larger reduction than itemizing the mortgage interest deduction with other deductions).

- The deduction of state & local taxes (including property tax) is now limited to $10,000. This is a negative development for individuals that reside in high-tax states.

- The child tax credit has been doubled from $1,000 to $2,000 per qualifying child under the age of 17. The child tax credit is now available to more people as the maximum income level was increased for single and married parents. The entire credit can be claimed by single parents who earn an adjusted gross income (AGI) of up to $200,000 (up from $75,000), and married couples who earn an AGI of up to $400,000 (up from $110,000).

- The alternative minimum tax (AMT) exemption amounts and phase-out thresholds have been increased. As a result, fewer tax payers will be subjected to AMT.

- The exemption amount for estate, gift and generation-skipping tax has been doubled, and is now roughly $11 million for individuals and $22 million for married couples (indexed for inflation).

- The tax rates for capital gains and dividends were left unchanged.

- In addition, a key provision in the Tax Cuts and Jobs Act is beneficial for non-corporate business owners (e.g. owners of sole proprietors, S-Corps, LLCs, and partnerships). These businesses are referred to as "pass-throughs" because business profits are passed through to the owners, and are then taxed at the owners' individual income tax rates. The new law allows for a 20% deduction of qualifying business income, which will lower the tax burden for business owners.

Potential Tax Reform Implications

The Tax Cuts and Jobs Act will almost certainly have a positive impact on economic and corporate profits in the near-term. However, the long-term impact is less certain.

- The majority of U.S.-domiciled corporations will experience an increase in net income, and many will invest at least a portion of this profit windfall in ways that should be positive for economic growth in the near-future. As mentioned in the previous section, corporations will have many choices in how to deploy this capital (some of which will be spent wisely, and some of which will inevitably be squandered).

- An increase in corporate earnings could help support equity prices that, by almost any measure, are currently trading at above-average valuations. While the impact of tax reform had been slowly priced into the financial markets prior to becoming law, even the impact on earnings per share will only become more apparent as companies are able to finalize their tax savings reinvestment plans (e.g. share repurchases – short-term impact on earnings; capital expenditures – longer-term impact on earnings).

- According to an estimate from The Tax Policy Center, 80% of all filers will experience a tax cut in 2018, with just roughly 5% experiencing a tax increase. Consequently, tax cuts will have an immediate positive impact on after tax income for many individuals just as wage inflation appears to be accelerating. As a result, consumer spending, which makes up the largest portion of U.S. gross domestic product (GDP), should receive a boost in the near-term. Longer-term, the Tax Foundation's Taxes and Growth Model estimates the new law will lead to 1.50% percent higher wages and an additional 339,000 full-time equivalent jobs over the next ten years.

- Changes in the tax code for small business owners could lead to greater reinvestment levels and hiring. The IRS estimates that about 95% of the businesses in the U.S. are pass-through entities and, according to the Tax Foundation, pass-through businesses account for over 55% of all private sector employment, representing over 65.5 million workers nationwide.

- The timing of tax reform is somewhat unusual given that the U.S. economy has been in an expansionary phase since 2009 (albeit while generating relatively low GDP growth) and, at the time tax reform was passed, the U.S. equity market was entrenched in the second longest bull market of all time. Fiscal stimulus is often enacted in response to slowing economic growth. In this case, many economic indicators had already begun to show improvement prior to the tax cuts becoming law, although the anticipation of tax reform getting passed likely played some role in this improvement. However, an argument can also be made for tax reform implementation being timely given that it provides significant fiscal stimulus as the Federal Reserve is backing off its unprecedented levels of monetary stimulus (i.e. could help ease the transition to a higher interest rate environment).

- Long-term estimates for the impact of tax reform on U.S. GDP vary considerably. For example, the Tax Foundation estimates the new law will increase GDP by 2.86% over pre-tax reform forecasts over the next decade, or an average of 0.29% per year. In contrast, the U.S. Treasury's Office of Tax Policy estimates the Tax Cuts and Jobs Act will increase GDP by 0.70% per year on average over the next ten years.

- Perhaps the most concerning element of the Tax Cuts and Jobs Act is the potential impact on the national debt level relative to GDP. According to The Congressional Budget Office (CBO) and The Joint Committee on Taxation, the Tax Cuts and Jobs Act will increase budget deficits and add roughly $1.8 trillion (including $300 billion in additional debt servicing costs) to U.S. debt over the next ten years. As a result, the CBO estimates that U.S. debt-to-GDP will increase to 97.5% by 2027 versus a June 2017 pre-tax reform estimate of 91.2% (according to the CBO, current debt-to-GDP is roughly 75%). U.S. debt-to-GDP could further deteriorate if tax cuts fail to add a meaningful corresponding increase in GDP growth over this time frame.

- The longer-term impact of these tax changes on inflation is also somewhat uncertain. On the surface, lower taxes should lead to higher levels of inflation as corporations and individuals have more to spend (higher demand for goods and services often leads to higher prices). However, many companies may choose to invest tax reform proceeds in price reductions in an effort to gain market share (lower taxes would allow many companies to grow profits even with lower selling prices). This type of behavior would likely be headwind for inflation.

While the exact position of an economic and market cycle only becomes fully apparent in hindsight, it's reasonable to assume that the current economic and market cycle is likely closer to the end than the beginning. Tax reform could ultimately extend this current cycle as the potential increase in profits and investment activity has a prolonged positive impact on economic growth. Conversely, the cycle could also be shortened if a flood of spending causes the economy and financial markets to overheat, and results in the rapid formation and unwinding of substantial asset bubbles.

In summary, the longer-term impact of tax reform on U.S. economic indicators, fiscal health and financial markets is far from certain. However, we believe our time-tested asset allocation approach and investment manager search and selection process should help to effectively navigate through an ever-changing investment landscape, and ultimately help construct portfolios that are best-positioned to deliver desirable long-term risk-adjusted returns.