THE Wealth REPORT

TAX REFORM: WHAT'S ON THE DOCKET

Overview

In June of 2016, House Republicans introduced a 35-page tax reform blueprint that called for "a better way" to achieve three important goals:[1]

- Fuel job creation and deliver opportunity for all Americans
- Simplify the broken tax code and make it fairer and less burdensome
- Transform the broken IRS into an agency focused on customer service

In April of 2017, the Trump administration released a one-page outline for tax reform, stating its objectives to:[2]

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families — especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

The following is a side-by-side comparison of some of the elements from the two proposals:

	2016 GOP Proposal	2017 Trump Proposal
Individual income brackets and rates	**12%, 25% & 33%**	**12%, 25% & 33%**
Alternative minimum tax	**Eliminated**	**Eliminated**
Estate tax	**Eliminated**	**Eliminated**
Standard deduction/ Personal exemptions	**• Larger standard deduction • Eliminate personal exemptions**	**• Double the standard deduction • Deduct dependent care expenses**
Deductions	**• Eliminate tax breaks that mainly benefit the wealthiest taxpayers • Protect home ownership and charitable gift tax deductions**	**• Eliminate tax breaks that mainly benefit the wealthiest taxpayers • Protect home ownership and charitable gift tax deductions**
Investment income	**50% deduction on capital gains, dividends and interest income, resulting in rates of 6%, 12.5% & 16.5%**	**No Information**
Corporate tax rate	**20%**	**15%**
Business reforms	**• Territorial tax system • Border adjustments exempting exports and taxing imports**	**• Territorial tax system • One-time tax on dollars held overseas • Eliminate tax breaks for special interests**

With a Republican president and the GOP controlling both houses of Congress, all the chess pieces are in place for meaningful tax reform. President Donald Trump and House Speaker Paul Ryan have each introduced proposals featuring reduced rates for individual and corporate taxes. While corporate tax reform enjoys broad bipartisan support, both sides of the aisle have grave concerns about how to pay for lower household income taxes.

It's difficult to conduct an apples-to-apples comparison because the Trump proposal lacks significant details, such as the income thresholds associated with individual tax rates. This also makes it impossible for the Congressional Budget Office to score the revenue cost of the changes. However, preliminary third-party estimates suggest his tax proposal could add up to $7 trillion to the national debt over the next decade.[3]

Corporate Tax Reform Issues

The United States' current corporate federal and state combined tax rate of about 39 percent is significantly higher than just about every other country in the world.[4] Most countries tax only the revenues earned within their borders. The U.S., on the other hand, taxes a wider base of income by levying taxes on all revenues no matter where they are earned throughout the world.[5]

As we have transitioned to a largely global economy over the past 15 years, this disadvantage has become more prevalent. The higher tax obligation makes it harder for American corporations to compete on the international market and provides an incentive for them to legally change their domicile to another country — a process called inversion.[6]

While an inversion can yield substantial tax savings for the reincorporated company, it means lower revenues for the U.S. Treasury and also can hurt the corporation's shareholders. When an inversion involves a stock transaction, the foreign company buys all the shares of ownership in the domestic corporation, which means the company's existing shareholders face capital gains taxes regardless of whether they become shareowners in the foreign corporation. The arrangement benefits both management and investors in the short-term because the company's stock price generally rises. However, an inversion may not represent the best long-term interests of U.S. shareholders.[7]

In theory, a large reduction in the corporate tax rate is expected to encourage more U.S. expansion and hiring while reducing the incentive to evade taxes. More jobs and higher wages could serve to increase the income tax base of individuals, thus increasing tax revenues in the long run. While some economists agree that a corporate tax cut would likely result in higher GDP and an increase in wages, many are skeptical that the cut would "pay for itself" in this manner, which is the administration's claim.[8]

The Tax Policy Center estimated the House GOP blueprint for tax reform would reduce federal revenues by $3.1 trillion and the federal debt would increase by at least $3.0 trillion in the first 10 years.[9] Based on those numbers, Trump's more dramatic reduction to 15 percent would likely result in a larger reduction in federal tax revenues and higher national debt. When you factor in his request for larger allocations to military and infrastructure spending, the combination may cause our current $20 trillion national debt to balloon even further. It is for this reason that even the bipartisan support for corporate tax reform is likely to experience a few bumps in the road.

Border Tax

While not included in his most recent proposal, Trump has repeatedly advocated taxing imported goods from certain countries, such as Mexico, to pay for a border wall. Alternatively, House Republican leaders have proposed implementing a 20 percent "border adjustment tax" from all countries. Such a tax is projected to bring in $1.2 trillion over 10 years, which would offset some of the revenue losses from lower tax rates. However, analysts point out U.S. consumers and businesses would fundamentally be paying for that extra revenue via higher prices on imported goods and raw materials.[10]

Legislative Process

The House of Representatives may be able to finagle enough votes for new tax legislation, but it will be much harder to get tax reform approved in the Senate, where a supermajority 60-vote is generally required. For the Senate to pass a bill with a simple-majority vote, it would have to pass a bill that does not add to the deficit outside the normal 10-year federal-budgeting window.[11]

Either way, Republicans are likely to be focused on how to pay for cuts, while Democrats will have to decide which potential budget cuts to support and which to defend.

The Wall Street Journal Endorsement...

"Mr. Trump's modernization would be a huge improvement on the current tax code that would give the economy a big lift, especially on the corporate side."[12]

Final Thoughts

The Trump era started with a huge boost from the stock market based on his pro-growth agenda. However, his first months in office have been fraught with missteps that have dampened prospects for fast passage of any meaningful legislation.

This situation is further complicated by a rift between moderate Republicans in Congress and members of the "Freedom Caucus," which has demonstrated its commitment not to pass any legislation that would add to the nation's debt.

Even if tax reform makes it out of Congress, potential implications for the overall market remain unclear. After all, the market favors confidence and certainty, and the past six months have been anything but that. While a tax overhaul featuring lower rates and simplified returns would no doubt be well-received, the passage of fiscally responsible tax reform legislation is a long way from a foregone conclusion.

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