Verdence View on Tax Cut and Jobs Act

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Overhauling the Outdated U.S. Tax System

This week Congress passed the most sweeping tax legislation in decades and President Trump signed it into law today (December 22). The vote was strictly along party lines with not one Democrat voting for the bill in either the House or the Senate. The Tax Cut and Jobs Act is the first substantial overhaul of the U.S. tax system since the Reagan era tax cuts in the 1980s.

At Verdence, we acknowledge that change is never easy, especially when it comes to something as important as paying Uncle Sam. Therefore, it is understandable that such a sweeping change to the current tax system would create excitement, concern, confusion, misinformation and opportunity. Clearly there will also be sensitivity around who benefits the most from the bill. Pundits from both sides of the political aisle will passionately make their cases. Additionally, there will be disagreement on the ultimate impact to the deficit. The deficit in the U.S. has grown significantly since the last recession in 2007-2009. In fact, public debt as a percentage of GDP has increased from 38% at the end of 2008 to 77% currently. Even before the current tax bill, every American child born in 2016 was handed a blanket and $42,000 in public debt.

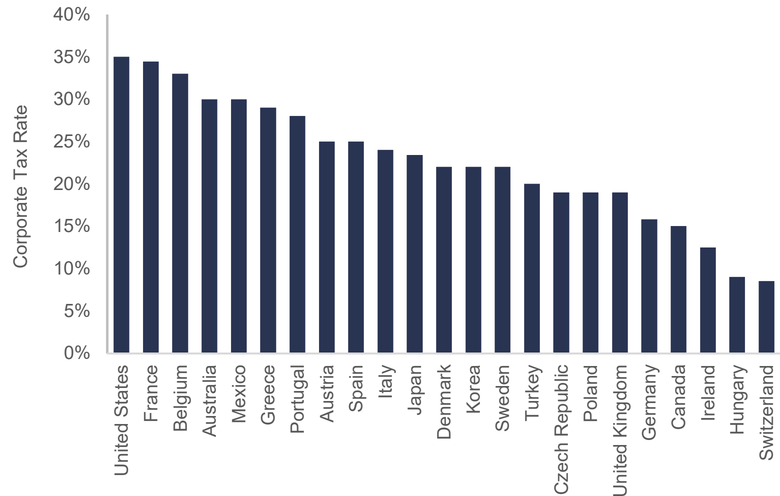
The ultimate effect on the deficit is unclear due to uncertainty surrounding the plan's impact on economic growth. Since the vote in the Senate was so close, there have been several changes to the bill over the last couple weeks. With all of this in mind, it is not surprising that Americans are unsettled regarding their "tax" bottom line and the future health of the economy. We will discuss some of the major issues that led to this legislation (from a corporate and individual perspective) the current details of the changes and our view of the tax overhaul.

Ancient tax system: The U.S. has operated under an outdated system called a worldwide tax system. In fact, according to the Tax Foundation there are only six countries that use a worldwide tax system (including the U.S.). The most basic explanation of a worldwide tax system; a company headquartered in the U.S. sells products overseas must pay the maximum determined U.S. tax rate regardless of where the sales take place. The overseas income can be deferred (after paying the local country tax rate) but gets taxed again once it is returned to the U.S. The new and more modern tax system that has been adopted by many major economies is the territorial tax system. In this system, the same U.S. company is exempt from paying U.S. income taxes on foreign earned income and only subject to paying the taxes in the country where the profit is generated. This is important since ~40% of the S&P 500 sales come from overseas. The outdated tax system has led companies to hold nearly $3 trillion of cash overseas or 10% of nominal GDP.

Past performance is not indicative of future returns.

Loss of competitiveness: Prior to the corporate tax cut, the U.S. had the highest corporate tax rate in the developed world (chart 1). This led to a lack of U.S. competitiveness and encouraged businesses to leave for countries with lower tax rates and use corporate tax inversions to minimize tax burdens. This action ultimately contributed to the decline in the U.S. manufacturing sector and financially impacted many middle-income families in major regions of the country. For example, the number of manufacturing jobs in the U.S. has fallen ~65% since their peak in the late 1970s or a loss of nearly seven million jobs.

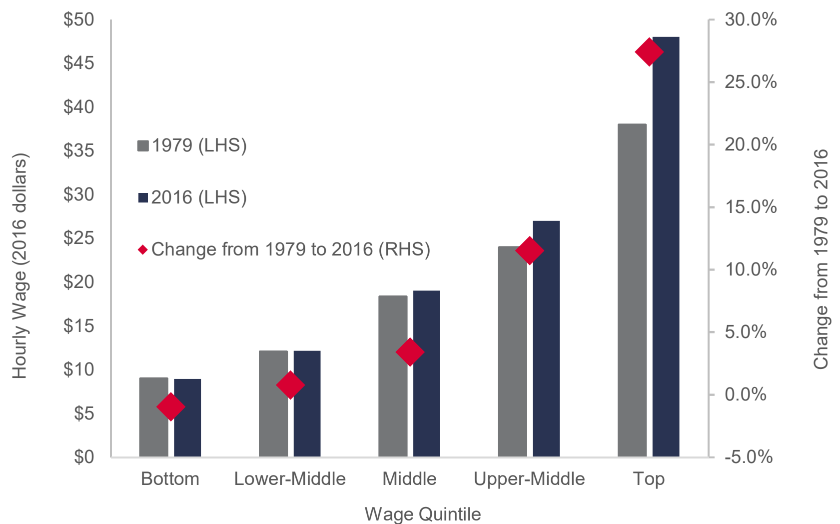
Chart 1: Global Corporate Tax Rates



Footnotes: Data as of 2016.
Source: Tax Foundation, Verdence Capital Advisors.

Lackluster wage growth: Wage growth, in aggregate, has been disappointing during this economic recovery. While wages have begun to accelerate as the labor market tightens further, the long term structural damage created by globalization and technology has been a political debate for decades. The top one percent of income earners account for ~20% of U.S. income, this is up from ~10% in the early 1980s. In fact, the top income earners in the U.S. have seen their hourly wages rise almost 30% since 1979 while the bottom income earners have been flat to slightly lower (chart 2). Despite unemployment at the lowest level since the turn of the century, according to Career Builder, nearly eight out of every 10 Americans reported that they are living paycheck to paycheck in 2017 and an increase from the survey in 2016.[1]

Chart 2: Real Wages in 2016 vs. 1979



Footnotes: Calculations as of 2016 by Brookings Institute with calculations from BLS.
Source: Brookings Institute, Verdence Capital Advisors.

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Below we outline the two main components of the tax bill (individual tax relief and the corporate tax cut) and our view on the tax bill.

Individual tax relief: There will be cuts across the board to the existing tax brackets.

- The new tax brackets will be 10% (with the potential of a zero bracket), 12%, 22%, 24%, 32%, 35% and 37%. The top tax bracket kicks in for those single filers making more than $500,000 and joint filers making over $600,000 (compared to $426,700 and $480,050, respectively). The individual tax cuts are temporary and will expire at the end of 2025.
- The standard deduction will increase for single taxpayers to $12,000 (from $6,350) and for married couples will increase to $24,000 (from $12,700).
- The child tax credit will nearly double from $1,000 to $2,000 and be eligible to higher income earners (single parents making up to $200,000 and married couple making up to $400,000).
- Individuals can only deduct up to $10,000 for sales, income and/or property taxes. This contrasts with the full deduction allowed in the past.
- Mortgage interest is still deductible for existing homeowners. However, in 2018, individuals can only deduct interest for mortgages up to $750,000. This will include first or second homes.
- Individuals will no longer be required to have health insurance. The Obamacare penalty had cost up to $695 per adult.
- The Alternative Minimum Tax will remain in place for individuals, but the threshold will be increased. The exemption for AMT will be increased from $84,500 to $109,400 for joint filers. The exemption phases out starting at $1,000,000 for joint filers, up from the $164,100 currently.
- The availability of 529 plans has been expanded from using only on higher education to using on public, private or religious elementary or secondary school (up to $10,000 per year).
- Student loan interest and tuition waivers received by graduate students will remain tax free.
- Medical bills that exceed 7.5% of taxpayers adjusted gross income can be deducted.
- The tax bill also doubles the estate tax exemption from $5.6 million to $11.2 million with an expiration of December 31, 2025.

Corporate tax cut: The corporate tax cut is significant, and some aspects of the bill are more detailed and far reaching than past corporate tax cuts (e.g. 1981, 1986 and 2003). Some of the details include:

- The corporate tax will be cut from 35% to 21% beginning in 2018 and be permanent. After accounting for state corporate taxes, it is estimated the combined tax rate will be between 25-26% but still be below all G7 countries.[2]
- The nearly $3 trillion in cash held overseas can be repatriated back at a one-time low tax rate of 15.5% for cash and 8% for reinvested foreign earnings.
- Full and immediate expensing of capital investments for five years and then is phased out over an additional five years.
- Small business expensing has increased from $500,000 to $1,000,000.
- Elimination of the corporate alternative minimum tax.
- Business pass through companies (e.g. LLCs, S corps) that make up ~95% of U.S. businesses will not see their tax rate cut to 21%. Instead, they will see a new 20% deduction for qualified business income and pay the remainder at their new individual (lowered) tax rate. The difference between the pass-through changes and changes for C corporations is that the C corporation tax rate will be made permanent while the pass-through changes expire along with individual tax changes (December 31, 2025). Certain providers (e.g. lawyers, financial etc.) will not receive the deduction if income is over the $315,000 threshold which is where the deduction phases out.
- Limits net interest expense to 30% of EBITDA for four years and 30% of EBIT thereafter.

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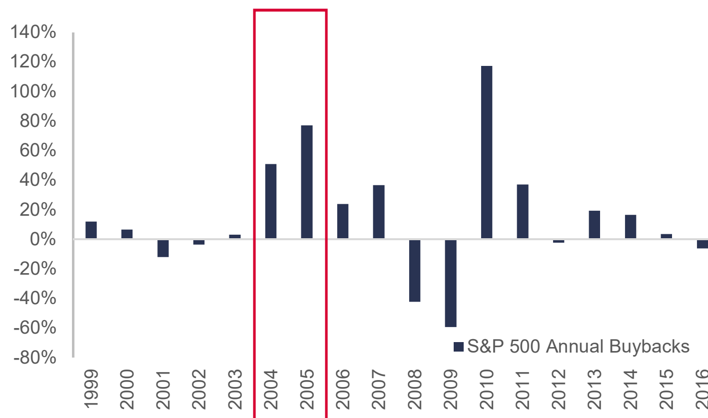
Chart 3: S&P 500 Annual Buybacks



Footnotes: Data as of 3Q17.
Source: Strategas Research Partners, Verdence Capital Advisors.

While the tax bill includes changes to individual taxes, our first assessment of the bill - it's a comprehensive stimulus package for corporations. While the corporate tax cut is substantial and brings the U.S. in line or lower than its trading partners, there are other facets of the tax bill we believe could have a more positive impact on economic growth. The 100% immediate expensing is extraordinarily beneficial for capital intensive businesses. The effect is expected to be more capex spending and potentially wage growth. Companies such as AT&T, Comcast and Wells Fargo are already reporting plans to increase capex spending and/or increase wages for employees. The tax repatriation releases a significant amount of money to be used to expand business operations in the U.S. Currently, there is ~$3 trillion of cash held overseas which is ~10% of nominal GDP. Companies can use this repatriated cash for capex spending, mergers and acquisitions or shareholder friendly activities. When using history as a guide, during the 2004 tax repatriation holiday, companies in the S&P 500 increased buybacks by 77% the following year (chart 3). While many blue-chip companies hold cash overseas, the biggest beneficiaries of the repatriation tax changes would be info tech companies.

On balance and in the short run, the individual tax changes may result in a modest reduction (positive impact is reduced unless the law is changed since sunsets in 2025) in taxes for most taxpayers. Taxpayers who may experience an increase are individuals with high incomes, high itemized deductions and living in states with high state and local income taxes. Lastly, the doubling of the estate tax from $5.6 million to $11.2 million is particularly helpful for wealthy individuals and has long been criticized as a death tax or double taxation. Since 2011, as wealth has grown, the amount of taxable estates has grown by 1,100. From an investment perspective, there are no changes to the taxation of capital gains or dividend income. While these changes do not take effect until 2018, individuals may want to consider the following tax planning items before year end:

- If allowed, prepay 2018 property taxes on your 2017 return.
- Due to 2018 standard deduction changes, many tax payers may not itemize their deductions so consider pulling charitable donations forward into 2017.
- Defer income into 2018 if possible.
- If buying a home (with substantial mortgage) consider closing by December 31, 2017 since the threshold for mortgage interest deduction is lowered to $750,000 in 2018.

The case for tax reform has been argued for decades by both parties. While both have very different views, they agree the current tax system is no longer viable for maximizing economic growth. Corporate America has long argued the current system puts them at a globally competitive disadvantage leading to reduced investment, operations moving overseas and trillions of dollars in capital being held outside our country. These factors have reduced economic growth and employment potential. Striking the right balance between fairness, adequate funding of our government and covering the needs of certain special interest (e.g. charities) is a difficult endeavor. We can say two things with certainty. First, this bill will not be perfect. Perfection is difficult in an economy as large and complex as ours. Second, tax accountants and lawyers are already busily combing through thousands of pages of the new tax code to exploit loopholes for individuals and corporations and we expect more opinions to be released in the coming weeks. That said, we believe this bill is an important and long overdue step to attempt to correct the imbalances and outdated segments of our current tax system. However, please consult your tax professional before making changes based on the new tax plan.

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[1] Career Builder as of August 2017.
[2] Strategas Research Partners as of December 16, 2017.

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