The tax reform of 2017 explained

Key takeaways:

- Recently introduced tax reform covers three main areas: taxes on individuals, taxes on corporations, and the way multinational companies are taxed, shifting from the current global system to a territorial one.
- While most changes for individuals are temporary (lasting one decade), many of the changes for corporations are permanent, including the transition from a global to a territorial system.
- It has been projected that the deficit will increase as a consequence (around $1.5 trillion in ten years), yet employment, consumption, the stock of capital, and the profits of American companies should all increase.

On December 22nd of 2017, President Donald Trump signed into law the biggest overhaul of the U.S. tax system since 1986. Unlike the latter, which commanded broad bipartisan support, this reform became law with Republican-only votes. Changes can be divided, broadly, into three categories: (*i*) those that affect individuals; (*ii*) those that relate to corporations; and (*iii*) the change from a global to a territorial system. In this paper we look at these changes, and also focus on the distributional and fiscal aspects of the reform.

1. Individual-tax reform

There are many changes in each of the three categories we will analyze. Regarding individuals, we analyze the most important ones, most of which are transitory (unless noted): they expire at the end of 2025. This had to be done in order to comply with Senate budget rules.

1.1. Individual tax rates

The number of brackets was kept at seven, but they changed:

TABLE 1

For single filers			
Current system		Tax reform	
10%	$0 - $9,325	10%	$0 - $9,525
15%	$9,326 - $37,950	12%	$9,526 - $38,700
25%	$37,951 - $91,900	22%	$38,701 - $82,500
28%	$91,901 - $191,650	24%	$82,501 - $157,500
33%	$191,651 - $416,700	32%	$157,501 - $200,000
35%	$416,701 - $418,400	35%	$200,001 - $500,000
39.6%	$418,401+	37%	$500,001+

Source: Innealta Capital.

TABLE 2

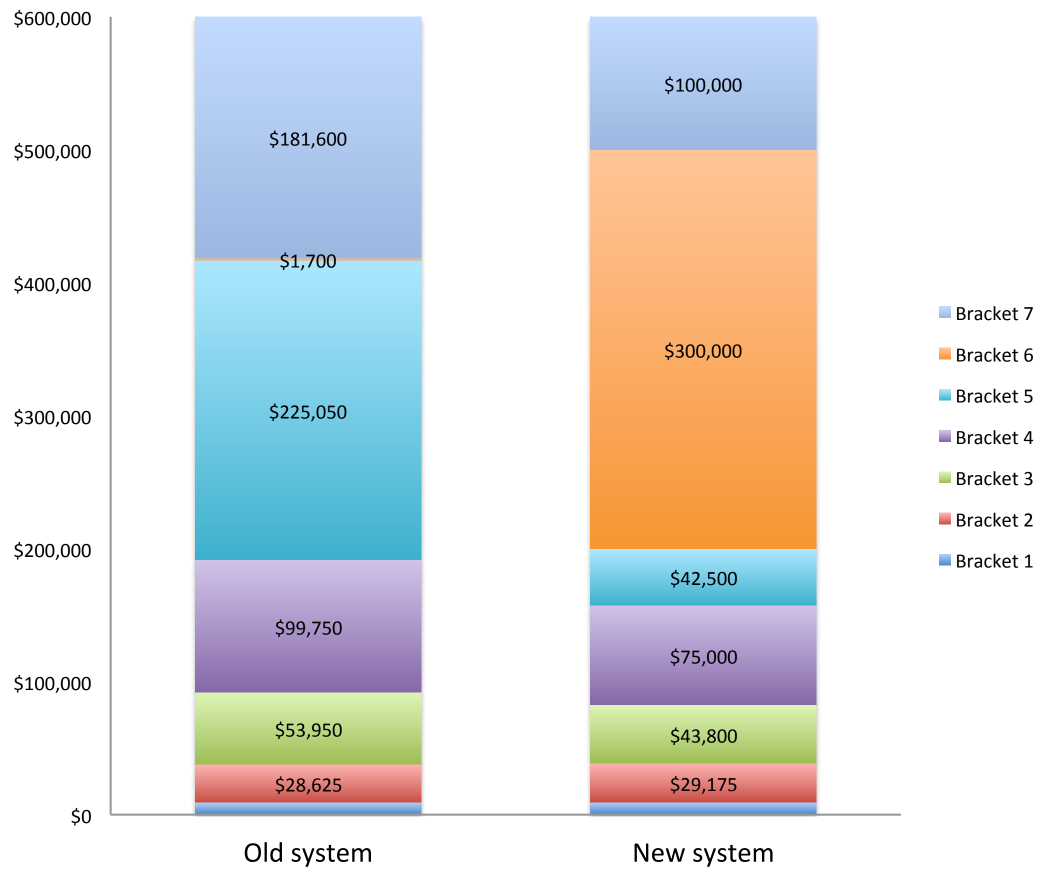
For joint filers			
Current system		Tax reform	
10%	$0 - $18,650	10%	$0 - $19,050
15%	$18,651 - $75,900	12%	$19,051 - $77,400
25%	$75,901 - $153,100	22%	$77,401 - $165,000
28%	$153,101 - $233,350	24%	$165,001 - $315,000
33%	$233,351 - $416,700	32%	$315,001 - $400,000
35%	$416,701 - $470,700	35%	$400,001 - $600,000
39.6%	$470,701+	37%	$600,001+

Source: Innealta Capital.

Figure 1

AN EXAMPLE: SINGLE FILER, $600K INCOME, AND THE AMOUNTS THAT FALL INTO EACH BRACKET.

Source: Innealta Capital (amounts for first bracket omitted).



1.2. Standard deduction

The standard deduction is a lump-sum deduction that provides taxpayers an advantageous alternative to itemizing deductions (e.g., state and local taxes, charitable donations, mortgage interests, medical expenses). Both options, which are mutually exclusive, help to reduce the amount of income that will end up being taxed. Around 75% of middle-class taxpayers take the standard deduction. The new law almost doubles the standard deduction: from $6,350 to $12,000 for single filers and from $12,700 to $24,000 for married taxpayers filing jointly. That means the overwhelming majority of the 75% of middle-class households we mentioned should get a tax break under the new rules.

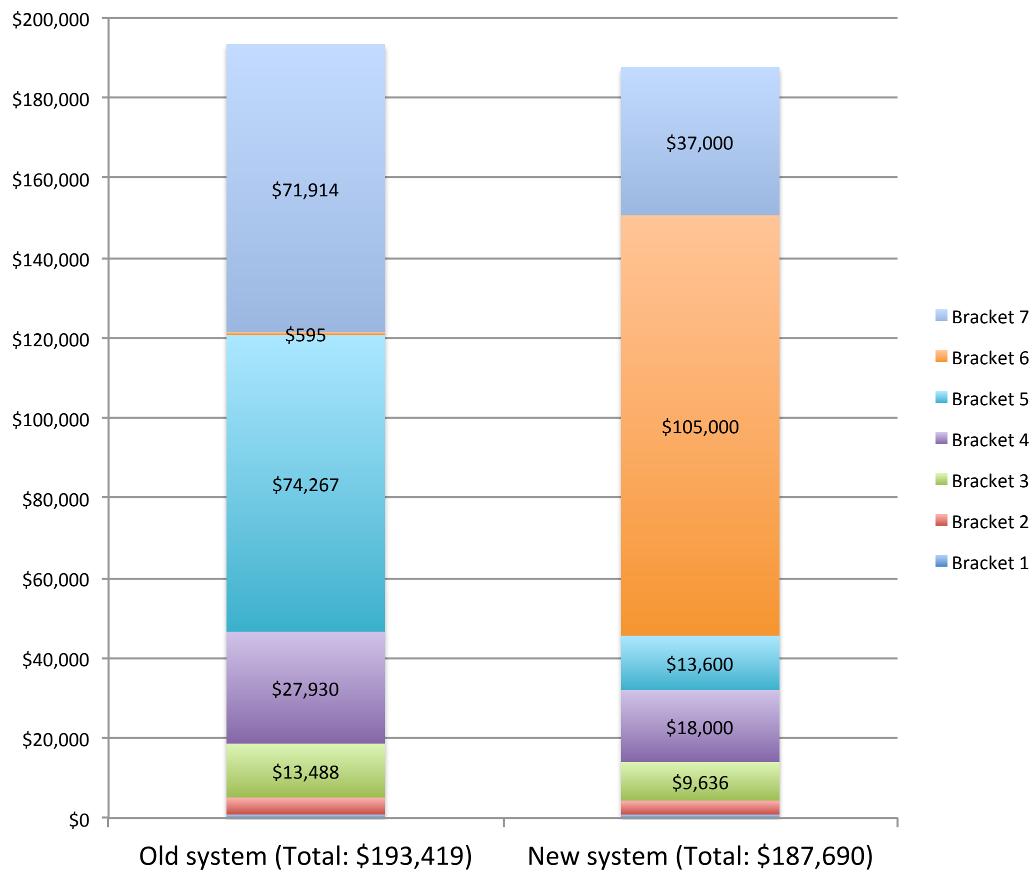
Of the remaining quarter (the ones who choose to itemize instead of taking the standard deduction), some will end up paying more, most likely those who live in high-tax areas and will now face a cap on the amount of local and state taxes they can itemize for deductions. Currently, people who itemize can choose between itemizing state taxes or sales taxes (but not both). Of course, most people go with state taxes, unless they happen to live in a state that has no income tax.

Whichever they choose, they can add their local property taxes to the amount deducted. The overall amount was unlimited, but the reform puts in place a cap of $10,000. So people living in a state with a high income-tax rate and who also pay high levels of property taxes – leading them to itemize deductions until now – may end up on the losing side if other breaks don't completely offset what they lose from the reduced deductions. (These will be high-income people: the non-profit, non-partisan Tax Foundation estimates that 90% of the benefit of these itemized deductions goes to taxpayers with incomes of $100,000 or more.) In any case, some states are studying measures in order to compensate potential losers. For example, California may take advantage of the fact that charitable-donation deductions are not capped, allowing residents to "re-route" their state-tax payments (i.e., donate to a state-controlled charity, credit the full amount towards the state income tax owed, and then deduct the donation from the income taxed at the federal level). The success of these measures is, at least, uncertain. In the case of California, the IRS may very well question whether there exists "charitable intent" in those contributions, which is generally considered a requirement for a donation to be deductible.

Figure 2

AN EXAMPLE: SINGLE FILER, $600K INCOME, AND THE AMOUNTS PAID AT EACH BRACKET. THE OVERALL TAX OWED IS REDUCED BY $5,729 (BEFORE DEDUCTIONS AND CREDITS).

Source: Innealta Capital (amounts for first two brackets omitted).



1.3. Personal exemption

This is a fixed amount that the taxpayer gets to deduct for every taxpayer and most dependents claimed on his return. This includes the taxpayer himself, as long as no one else is claiming him as a dependent – the main rule is one exemption per person. The personal exemption (currently, $4,050 for single filers and $8,100 for married taxpayers filing jointly) is eliminated by the reform.

1.4. Alternative inflation measure (permanent)

Tax brackets will now be indexed using the so-called chained CPI, instead of just the CPI. In a nutshell, the former takes substitution patterns into account (the basket of goods is not fixed), and therefore would theoretically not overstate inflation the way the CPI does. Consequently, tax brackets will be adjusted in a way in which it will be easier for taxpayers to hit higher ones in the future (because the brackets are being adjusted at a lower rate than wages).

1.5. Child tax credit

The maximum available credit is doubled from $1,000 to $2,000 per child. A credit is subtracted directly from the tax liability, not from taxable income. This credit depends on income and the qualifying child meeting certain conditions. The new credit includes up to $1,400 that are refundable, i.e., they can be taken advantage of even if no tax is owed (thus making the tax rate negative).

1.6. Alternative minimum tax

The AMT effectively sets a minimum amount the taxpayer must pay. It is computed over all taxable income, after allowing for an exemption (deduction). Many of the regular deductions are not permitted or are reduced in this calculation (like local and state taxes, e.g.). The goal is not allow some people to get away with "too low" a tax rate. Approximately 5 million households are affected by it, and the AMT accounts for 2.5% of all individual-income-tax revenue. It mostly affects households with incomes between $200k and $1m, especially those with children and living in high-income-tax states. The change the tax reform introduces comes in the exemption amount, which has been raised, meaning fewer people will end up being hit by the AMT (i.e., it becomes less likely that the AMT will be greater than the regularly computed tax amount).

1.7. Estate tax

The exemption has been doubled. Currently, a 40% tax applies to estates worth more than $5.49 million (single filers) or $10.98 million (joint filers).

1.8. Mortgage-interest deductions

The current $1 million cap is reduced to $750,000 (the original House bill set the cap at $500,000). The cap will be the same for a second home. The number of people itemizing this deduction will consequently drop. The larger standard deduction and the cap ($10,000) on state and local property-tax deductions should reinforce this effect.

1.9. ACA mandate (permanent)

There will be no penalty assessed for not buying health insurance. This should discourage healthier individuals who do not have health insurance through their employers from buying into a plan (leaving behind a riskier pool, which in turn should make health-care premiums go up).

1.10. Pass-through businesses

People who receive income from pass-through businesses ("S-corporations") that meet certain requirements will be allowed to deduct 20% of that income from their individual income tax. These corporations pay tax through the individual income tax code.

1.11. Carried interest

The so-called carried-interest loophole remains intact. This allows hedge-fund managers to pay a lower tax for their share of the fund's profit, relative to what they would be charged if that money were treated as regular income instead of capital gains (they are taxed usually at 20%, when the marginal tax rate for income can reach 39.6%, or 37% under the reform). There is only one and relatively minor change: assets will need to be held for three years, instead of just one. So we can expect short-period investments to become less attractive for private-equity firms.

2. Business-tax reform

The most significant change here is the reduction in the corporate-tax rate from 35% to 21%. The 35% rate is, however, the statutory tax rate; the effective tax rate for U.S. companies is less after accounting for several deductions and exemptions (the Congressional Budget Office estimated it at 18.6%). All else equal, profits will increase. Telecom companies, which pay the highest effective tax rate according to estimates, stand to benefit the most. Consumer staples and consumer discretionary are the sectors that follow. Regarding banks, KBW Research estimates a 20% increase in profits or more for JPMorgan Chase, Wells Fargo, and Bank of America. Small-caps should also benefit from such a big reduction in corporate rates, given that they have fewer resources to devise ways to reduce their effective rates. The biggest loser will probably be real estate in high-tax states, given that the federal-tax deductions will now be capped.

Another major change is in the treatment of depreciation: instead of smoothing out an amount over several years, now everything will be expensed immediately (starting in 2018 and until 2022; this bonus rate of depreciation is then phased out, ending in 2026). This should spur capital investment. Companies will be allowed to take advantage of this in 2017 (property acquired after 9/27/17), at the 35% rate. (And then they will earn their income and have it taxed at 21%.)

Finally, another important change has to do with interest deductibility: there will be a limit on net interest deductions. This will be set at 30% of adjusted taxable income. Financing decisions and capital structures should respond to this change by moving away from debt.

3. International-tax reform

The global system currently implemented by the U.S. will change to a territorial one, meaning U.S. firms will no longer pay tax on their worldwide profits, just the portion made in the U.S. This will align the United States with the rest of the world, reducing the incentives to leave the country (via corporate inversions, e.g.). There will also be a one-time tax on corporate profits sitting overseas, which to a large extent have not been repatriated to defer taxes. (Taxes are applied only when the money is brought back home.) The tax will be of 8% for illiquid assets, and 15.5% for liquid assets. The idea behind this is two-fold: reduce the impact on the deficit of the entire plan and encourage American firms to repatriate the money they have in foreign countries. Moody's estimates at $1.3 trillion the amount of cash that American companies have stashed abroad. Apple, Microsoft, Alphabet, Cisco and Oracle are the top 5 in this category, and are estimated to have 88% of their money overseas.

Another important change comes from (many) new rules regarding taxation of multinational firms, especially concerning intellectual property. The goal is to avoid profit shifting – via transfer prices – to low-tax locations. For example, the Base erosion and anti-abuse tax is introduced, which will tax intra-firm transactions at 10% if they seem part of an effort to shift profits outside of the country.

Additionally, the new law includes a provision that could end up being challenged by other countries as constituting an unfair (that is, illegal) export subsidy. Although the rules here are quite convoluted, a greater share of income derived from exports will be taxed at 12.5% (intangible property and services), instead of the new general rate of 21%. The World Trade Organization may be called upon to resolve this.

4. Fiscal impact

Not many studies have been released analyzing the potential impact of the reform. The main reason is probably the little time elapsed since the bill was first introduced and its signing into law – seven weeks. According to the U.S. Congress Joint Committee on Taxation (non-partisan), in the period 2018-2027 an extra $1.456 trillion will be added to the deficit as a direct consequence of this reform (i.e., not taking into account the extra revenue that may come from increased growth). If the individual-tax reductions that are set to expire in 2025 were extended, that number would of course go up. The estimation for the increase in the fiscal deficit is broken down as follows:

TABLE 3

Contribution to budget deficit 2018-2027 (USD trillions)	
Individual-tax reform	$1.1266
Business-tax reform	$0.6538
International-tax reform	-$0.3244
Total	**$1.456**

Source: Innealta Capital.

Hence, most of the deficit enlargement comes from individual-tax reform. International-tax reform actually helps to partially offset the decrease in revenues that the other two reforms will generate. Moreover, 2027 is the only year where the reform is expected to help boost the government's coffers (by almost $33 billion).

Within individual-tax reform, the biggest contributor to the deficit is the change in income-tax brackets ($1.2142 trillion). However, this amount is almost completely offset by the repeal of the deduction for personal exemptions, which is estimated to add $1.2115 trillion over the next decade. Other big contributors to the deficit are the increase in the standard deduction ($0.7204 trillion), the modification of the child tax credit ($0.5734 trillion), and the increase in the individual AMT exemption amounts ($0.6371 trillion). On the other hand, the repeal of itemized deductions will be the second largest contributor of government revenue in the individual category ($0.6684 trillion). The new inflation measure also contributes ($0.1335 trillion). The Congressional Budget Office (non-partisan) has estimated repealing the health-care mandate could save $0.338 trillion, with the number of uninsured rising by 13 million in the next decade.

When it comes to business-tax reform, the biggest offender is, by far and as expected, the new corporate tax rate of 21%: it is projected to add $1.3485 trillion to the deficit in the next ten years. Of the changes that add revenue, the limit in net interest deductions (up to 30% of adjusted taxable income) contributes the most: $ 0.2534 trillion.

Finally, international-tax reform adds $0.2236 trillion to the deficit via the deduction for dividends received by domestic corporations from certain foreign corporations, but brings in substantial revenue from taxing profits stashed abroad ("deferred foreign income", $0.3388 trillion) and other changes.

5. Distributional impact

One concern is that, given the temporary nature of tax reductions for individuals, after 2025 the benefits will accrue mostly to higher earners. The lower corporate rate will benefit shareholders, which are concentrated at the top of the income distribution. The same happens with the benefits given to pass-through businesses and the new individual-tax brackets (although these benefits are temporary). Once again using the estimates of the Joint Committee on Taxation , in 2027 it is estimated that people earning more than $75,000 will pay less in tax under the new law, whereas the rest will pay more. This would change if the benefits set to expire at the end of 2025 were extended, something Republicans have said will happen. As for wages, a part of the tax savings corporations will enjoy should be passed onto workers in the form of increased wages. The size of this effect is of course a matter of debate.

6. Macroeconomic impact

The Joint Committee on Taxation estimates that "the net effect of the changes to the individual income tax is to reduce average tax rates on wage income by about one percentage point, while reducing effective marginal tax rates on wages by about 2.5 percentage points until the expiration of the individual income tax provisions." They also agree that the after-tax cost of capital is reduced and therefore the after-tax return on business investments will go up. As for GDP growth, they claim that the reform "would increase the level of GDP relative to the baseline forecast, by 0.7 percent on average throughout the ten-year budget window." The room for extra growth is limited in an economy where unemployment is already low, yet the projections take into account an increased supply of labor (explained by higher after-tax returns to working): "On average, employment is projected to increase by about 0.6 percent relative to baseline levels during the budget period." Consumption should also increase (0.7 percentage points on average during the next decade). The Committee notes that, if temporary tax breaks for individuals are not renewed, the incentives to work are reversed after the first ten years, given that chained CPI will continue to be used to calculate tax brackets. That is, the marginal tax rate on labor would go up.

Another important consideration is the effect on the capital stock available for production, which is expected to be 0.9 percentage points higher than the baseline forecast on average throughout the next ten years. The analysis takes into account the increase in depreciation rates and the incentives for multinational companies not to relocate abroad (including reductions in profit shifting).

Conclusion

The tax-reform bill that was signed into law on December 22nd of 2017 represents a major transformation of the U.S. tax code. The most important changes are the reduction in corporate-tax rates and the move from a global to a territorial system. Many of the other changes, while important, are currently temporary, with most of them set to expire at the end of 2025. From a fiscal perspective, the new system will add, according to estimates, $1.456 trillion to the deficit over the next decade. In terms of income distribution, it should make it more unequal. From a macroeconomic standpoint, employment, consumption, and the capital stock available for production should all increase in the next ten years.

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