MORNING BRIEFING
October 4, 2017

Taxing Tax Reform

(1) Crib sheet for unwritten plan. (2) Campaign promises vs. White House "framework." (3) Hit to revenues offset by implicit elimination of state & local tax deduction. (4) There's a new fourth tax rate to keep tax reform progressive. (5) Pass-throughs should still get a big windfall. (6) Corporate tax rate: 15% has been raised to non-negotiable 20%. (7) Mnuchin says it will pay for itself. (8) Repatriation story just got more complicated. (9) Border tax is dead.

US Tax Reform: Retooled. The Trump administration's 9/27 *Unified Framework for Fixing Our Broken Tax Code* is essentially an outline. The President is leaving it up to Congress to fill in the details that will make it a plan. The Republicans need to make tax reform the law of the land to hold onto their slim majorities in both houses of Congress come next year's mid-term elections. They might fail as miserably on this challenge as they did on repealing and reforming Obamacare, when their majority splintered and not one Democrat in either the House or the Senate supported their effort.

In this case, the President might have to reach out to "Nancy and Chuck" to formulate a bipartisan tax reform bill. What are the odds that the Democrats would give the Republicans any tax reform that they could tout as their own during the upcoming election? Slim to none is the obvious answer.

Politics aside, let's look at the latest White House framework. How does it differ from Trump's tax-related campaign promises? Are there any key changes that might affect how investors reshuffle portfolios? That's hard to say, given the scant details in the latest framework; for now, let's work with the big-picture numbers that we do have.

The upshot is that the new framework is far less costly to the government than the one proposed during the campaign. Let's compare:

(1) *Lighter revenue hit.* The non-partisan Tax Policy Center (TPC) estimated the revenue effects over the next 10 years of the Trump campaign's October 2016 proposal in a published analysis and did a similar preliminary analysis of the new White House framework. It's important to caveat that the analyses, the latter one especially, are based on a lot of assumptions given the lack of details. That said, the bottom line came in approximately $3.7 trillion less costly for the White House framework than Trump's campaign proposal over the next 10 years.

To trace that figure to its source documents, see the bottom of Table 1 in the TPC's updated analysis (reducing revenues by about $2.4 trillion) and compare that to the older analysis Table 2 (costing $6.2 trillion). Another caveat: These figures are based on different 10-year periods, specifically 2018-2027, for the updated analysis and 2016-2026 for the older one.

(By the way, another often-cited analysis, done by the Committee for a Responsible Federal Budget, pegged the net cost of the framework at $2.2 trillion, not far from the TPC's bottom line.)

(2) *State of individuals.* Melissa prepared an updated table comparing the estimated revenue impacts of the latest White House framework with those of the Trump campaign proposal using TPC estimates

(*Table 1*). Taxes changes are skewed toward individuals more than pass-through entities and corporations.

The new White House framework has nearly $1.7 trillion in additional revenue from individuals. Much of it appears to come from repealing the state and local tax deduction, which adds about $1.3 trillion to revenue (offset by changes to estimates for other itemized deductions), according to the TPC's latest analysis.

The state and local tax deduction isn't specifically mentioned in the White House framework. The TPC likely culled it from the White House framework, which states: "In order to simplify the tax code, the framework eliminates most itemized deductions, but retains tax incentives for home mortgage interest and charitable contributions." In other words, the state and local tax deduction is not retained.

That's a really big sticking point for Republicans from high-tax states who want to keep that tax break, observed a 9/29 Bloomberg article. Bloomberg reported that President Trump is open to negotiating on this matter. Another hot topic that Congress will surely debate is eliminating the medical expense deduction, as discussed in a 9/29 *WSJ* article, "A Big Tax Question: What Happens to the Medical-Expense Deduction?"

(3) *Bones for progressives*. In addition to eliminating the state and local deduction, there was a sizable giveback for individual tax rates on high-income earners. In the new White House framework, the tax rate for top earners was increased to 35.0%, generating more revenues than the 33.0% proposed in the original Trump campaign's tax plan. Even so, the move still benefits high-income earners, as the top marginal income tax rate currently stands at 39.6%.

The change clearly was a bone tossed to Democrats who argued that Trump's campaign proposal overly and overtly favored the wealthy. Perhaps in a futile gesture to get some Democratic support, the framework provides for a top fourth bracket: "An additional top rate may apply to the highest-income taxpayers to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers." Meanwhile, the tax rates for the two lowest of the three income brackets were kept the same in the framework as in the campaign proposal at 12.0% and 25.0%. But how much income will determine each bracket is unknown, as Business Insider pointed out in a 9/27 article.

(4) *Pass-through loops*. Pass-through entities wouldn't benefit as much from the White House framework as they would have under the Trump campaign proposal. A hallmark of the Trump campaign's tax proposal was the flat 15.0% tax rate for pass-throughs. The latest framework earmarks the pass-through rate at 25.0%. The current framework would cost the government $1.4 trillion less than the campaign proposal for the treatment of pass-through entities, according to the TPC.

About half of the $1.4 trillion reflects the higher pass-through rate, including the TPC's estimates of the potential recharacterization of income. The source of the other half of the difference is less clear. From the TPC's analyses, the other half seems to come from no longer allowing a line item for investments and equipment to be expensed (as opposed to capitalized). Expensing of capital investments for businesses is mentioned in the new White House framework, but is not specifically tied to pass-through entities, so that's probably why the TPC opted to exclude it in the new analysis.

Though the rate for pass-throughs was increased for the framework, "[t]he real fight [in Congress] is going to be over what income qualifies for the rate reduction and what income doesn't," said a former House GOP aide quoted in a 9/24 Fox Business article. The TPC included in its analyses assumptions that individuals would seek to recharacterize wages (fairly or unfairly) as "pass-through income" to

qualify for the lower rate.

The new framework suggests that the White House would adopt rules to prevent unfair recharacterization of income. Earlier in September, Steve Mnuchin specified: "If you're an accountant firm and that's clearly income, you'll be taxed an income rate, you won't be taxed a pass-through rate. If you're a business that's creating manufacturing jobs, you're going to get the benefit of that rate because that's going to be passed through to help create jobs and better wages."

So small businesses that create jobs stand to significantly benefit from the latest White House framework. Juanita Duggan, the NFIB President and CEO, was right on 9/19 when she told the Senate Finance Committee: "If the purpose of tax reform is to jump-start the economy and create jobs, then tax reform must start with small business."

Indeed, small and medium-sized companies are disproportionately big employers, according to ADP's monthly tally of payrolls, as we discussed in our 6/14 *Morning Briefing*. Recently, small business owners have reported that they have lots more jobs to fill but can't find enough qualified workers to fill them. It's possible that the pending tax reform will help to free up some capital for small businesses to raise wages and better afford qualified workers, assuming they're out there.

(5) *New corporate rate target.* Overall, the change from the campaign proposal to the framework isn't as significant for corporations as for individuals and pass-throughs. The statutory federal rate stands at 35.0% now, was 15.0% in the Trump's campaign proposal, and has been increased to 20.0% for the framework. Trump reportedly will not negotiate any further on it, according to Gary Cohen, reported Bloomberg. Trump also recently called 20.0% a "perfect number."

The change could add back about $400 billion in revenue, per the TPC analysis. But that can't be very exact, since the new framework lacks sufficient details on how corporate deductions would impact effective corporate tax rates. Further, there's another $400 billion or so addback in the latest TPC analysis related to less aggressive allowances for business expensing of capital investments.

(6) *Macro feedback MIA.* Melissa and I aren't surprised that the "Big 6" fiscal policymakers who developed the framework found several trillions of dollars to add back to revenue from Trump's campaign dreams. Before Trump came on the political scene, members of the GOP had introduced a similar blueprint for tax reform to Congress. Melissa and I reviewed the earlier proposal in our 5/1 *Morning Briefing,* highlighting that the TPC estimated the cost of the original blueprint at around $2.5 trillion, close to the recently released framework's level (*Table 2*).

So it appears that the Big 6, the group of high-profile tax policymakers who are fully backed by President Trump, had that top-level figure in mind when developing the framework. The group, named in a 7/27 joint statement, includes: House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, Senate Finance Committee Chairman Orrin Hatch (R-UT), and House Ways and Means Committee Chairman Kevin Brady (R-TX).

Steve Mnuchin recently said that the framework should more than pay for itself. According to a 9/28 Dow Jones Newswire posted on Fox Business, he "argued that any measure of the tax cut should disregard about $500 billion in expired and expiring tax breaks that Congress was going to extend anyway. That would make the total cut smaller, at approximately $1 trillion, he said. A $1 trillion tax cut generating $2 trillion in revenue, would leave an extra $1 trillion to help pay down the debt, Mr. Mnuchin concluded."

Mnuchin's calling out of a $1 trillion cut could be important. Connecting the dots to a fact found in a 9/27 *Forbes* article, the reconciliation process—which would streamline the Trump administration's tax reform pursuit in Congress—allows for only $1.5 trillion in tax cuts.

Whatever the targeted number might be, Mnuchin's cuts don't reconcile with the TPC's analysis. Neither do his estimated economic effects. In the TPC's analysis, the effects were miniscule compared to the cuts. The TPC does not have a new "Macro Feedback" estimate for President Trump's latest proposal, but notes in its report that it is forthcoming.

Who knows who is right about the framework's economic impacts? If the framework materializes into law, the impacts will be tough to estimate going forward and even more difficult to prove 10 years from now.

(7) *Forced repatriation*. Beyond that, Melissa and I particularly want to better understand the potential effects of the repatriation tax on the financial markets. Investors seem to be betting that it will turn out to be quite bullish for domestic equities. In a 10/1 interview with Maria Bartiromo, Gary Cohn said that the White House is looking to bring back nearly $3 trillion in profits stashed overseas.

The questionable new news in the new framework is that it implies that such repatriation will not be optional. It states: "To transition to this new system, the framework treats foreign earnings that have accumulated overseas under the old system as repatriated." Melissa and I don't recall the initial discussions on repatriation as having been focused on forcing the issue.

Going forward, the framework notes: "To prevent companies from shifting profits to tax havens, the framework includes rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations." US multinational corporate lobbyists, according to a 10/2 Bloomberg article, see that as an "appalling" new tax on US companies foreign profits.

But it isn't all bad news. Don't forget that the repatriation tax should be offset by the lower corporate tax rates discussed above. What's more, the existing overseas profits would be taxed at a much lower, one-time retroactive tax rate payable over a period of time. The framework didn't specify the rate. Neither did Cohn in his interview. In its latest analysis, the TPC estimated the one-time rates to be the same as in the 2014 proposal of former House Ways and Means Chairman Dave Camp, i.e., 8.75% on accumulated foreign earnings in cash and 3.5% for non-cash, payable over eight years.

However, Cohn did say that the rate would be bifurcated—a different rate for liquid assets offshore and another for those that have turned earnings into bricks-and-mortar or investments offshore. He said: "We will give [companies] some period of time to pay it, but [they] will incur the tax liability the minute the tax referendum goes through."

(8) *Border tax axed.* By the way, the controversial concept of a border tax was dropped prior to the release of the White House's September framework. On July 27, in the previously referenced joint statement, the Big 6 concluded: "While we have debated the pro-growth benefits of border adjustability, we appreciate that there are many unknowns associated with it and have decided to set this policy aside in order to advance tax reform." (For more, see the 7/27 *NYT* article on the subject.)

CALENDARS

US. Wed: ADP Employment 150k, ISM & Markit M-PMIs 55.4/55.1, MBA Mortgage Applications, EIA Petroleum Status Report, Yellen. **Thurs:** Factory Orders 1.0%, Merchandise Trade Balance -$42.5b, Jobless Claims 265k, Challenger Job-Cuts Report, Weekly Consumer Comfort Index, EIA Natural Gas

Report, Powell, Harker. (Bloomberg estimates)

Global. Wed: Eurozone, Germany, France, and Italy Composite PMIs 56.7/57.8/57.2/55.9, Eurozone, Germany, France, and Italy Nonmanufacturing PMIs 55.6/55.6/57.1/55.0, UK Composite & Nonmanufacturing PMIs 53.8/53.2, Eurozone Retail Sales 0.3%m/m/2.6%y/y. **Thurs:** ECB Account of the Monetary Policy Meeting. (DailyFX estimates)

US ECONOMIC INDICATORS

Auto Sales (*link*): Motor vehicle sales in September shot up to the highest reading in a dozen years, as consumers in hurricane-hit parts of the country replaced flood-damaged cars. Sales jumped from a 42-month low of 16.1mu in August to 18.6mu (saar) last month—the highest reading since July 2005. The rebound was widespread, led by a 1.4mu jump in domestic light truck sales to 9.7mu, its strongest showing since the summer of 2005; domestic car sales climbed to 5.0mu (saar) after eight months below. Sales of imports reached its fastest pace since August 2009, advancing to 3.9mu (saar) after fluctuating in a multi-year flat trend.

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