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Tax Reform—Questions and Answers for Investors

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Key Takeaways

» *Congressional leaders are pushing to complete tax-reform legislation by year-end.*

» *The House and Senate bills differ materially. We note the key provisions to watch.*

What It May Mean for Investors

» *Market reaction remains cautious, while the details are fluid. Yet, modest economic stimulus is likely to result from any completed tax-reform legislation.*

Congress has been moving at an impressive speed not seen since the 2016 elections in an attempt to get tax-reform legislation across the finish line before year-end. Both the House and Senate have been hard at work on their own bills, and this process remains fluid. In today's report, we address a few of the most frequent questions we are receiving on tax reform.

1. What is the projected timeline?

Last week: Both chambers of Congress completed two important process steps on the path to tax-reform legislation. The House voted 227-205 to approve its version of tax reform, and the Senate Finance Committee approved its tax-reform bill on a party-line vote of 14-12, sending the new version to the Senate floor for consideration.

Week of November 20th: Both chambers are adjourned for the Thanksgiving break.

Week of November 27th: The Senate will formally return on Monday, November 27; the House returns on Tuesday, November 28. We expect that the key hurdle for tax reform will be the full Senate vote on its bill, probably late in the week of November 27.

Week of December 4th: If the Senate successfully passes its bill, the next step is closed-door work for a conference committee to return a compromise bill for a vote in each chamber.

Week of December 11th: The final bill goes back to the House and the Senate for a final approval vote and then is sent to the president to sign into law.

What if it takes longer? If the process is delayed, and if the Republicans lose a Senate seat in a December 12 special election in Alabama, Senate leaders may have to push for more modest provisions, especially on the corporate-tax side.

One substantial challenge within this timeline remains on December 8, when the continuing resolution that funds the U.S. government expires, possibly triggering a partial government shutdown. Also, after December 8, the U.S. Treasury Department will invoke extraordinary cash-saving measures to facilitate public debt payments until the debt ceiling can be raised, probably in late February.

2. How large and impactful are the proposed tax cuts?

Both plans propose tax reductions in the amount of $1.5 trillion over a period of 10 years. With that said, if the expiring provisions within each plan are included, the net tax reduction is closer to $1 trillion over the next decade. If we assume that individuals will save some of the $100 billion in tax cuts given each year for 10 years, we believe that the economic stimulus should be modest.

3. What are the key differences between the House and Senate bills?

We highlight below a few of the prominent differences that still need to be worked out between the two bills.

Individual Income Tax Brackets: The House bill proposes four individual income tax brackets (12, 25, 35, and 39.6 percent), while the Senate bill proposes seven individual tax brackets (10, 12, 22, 24, 32, 35, and 38.5 percent).

Estate/Gift Tax: Both bills would double the estate/gift tax exemption. Yet, the House bill repeals the estate tax after 2024, and the Senate bill proposes no estate-tax repeal.

Itemized Deductions: The House bill limits itemized deductions, including a $10,000 property-tax-deduction limit and a $500,000 mortgage-interest cap. The Senate bill proposes to eliminate state and local tax deductibility and home-equity interest, but to maintain mortgage-interest deductibility.

Corporate Tax Rates: Both bills propose a 20 percent corporate tax rate—with the House bill making it effective in 2018, and the Senate bill proposing 2019 as the effective date.

Corporate Interest Deductibility: Both bills limit net interest deductions for corporations to 30 percent.

Corporate Depreciation Expensing: Both bills propose 100 percent depreciation expensing until 2022, when this provision would expire in each plan.

Repatriation of Overseas Profits: The House bill proposes a 14 percent tax on liquid assets and a 7 percent tax on illiquid assets. The Senate bill proposes a 10 percent tax on liquid assets and a 5 percent tax on illiquid assets.

Permanent versus Temporary: The Senate bill would make corporate-tax reform permanent, while making individual and small business tax cuts expire in 2025. The House bill would make all proposed changes permanent.

4. Where are the sticking points to getting tax reform done?

Momentum often begets momentum, and the progress made by both chambers thus far has exceeded most expectations. Yet, key challenges remain, particularly within the Senate, where the tax-plan math is more precarious. The Senate is currently split 52-48 (Republicans to Democrats). That means that Republicans can only lose two votes in the U.S. Senate—pending the Alabama special election—and still achieve passage of the Senate tax bill, since most votes have remained along party lines. We would watch two items, in particular. One of these is the fact that inclusion of the repeal of the individual mandate to purchase health insurance within the Affordable Care Act (ACA) could prove controversial for some senators who recently voted against the earlier repeal and replace legislation on the ACA. This provision was added to the Senate bill—as it generates more than $300 billion of savings over 10 years within the Senate plan, and it helps to make the math work to remain at the $1.5 trillion tax-cut cap.

The second key item to watch is the fact that the elimination of state and local tax (SALT) deductions within the Senate bill also has come under much scrutiny, particularly within states with relatively high state and local tax regimes, such as California, New York, Connecticut, New Jersey and Illinois. The House bill would cap the deduction for state and local property taxes at $10,000 but would eliminate the deductions for state and local income or sales taxes. The Senate Finance Committee version would repeal all the deductions for state and local income, sales, and property taxes. If this version passes the Senate, the conference committee negotiations to reconcile the two versions could be difficult.

5. Is tax reform priced into markets already?

It does not appear that much anticipation of tax reform is discounted in the markets today. Most markets appear to be moving on growth and inflation expectations—and not on developments in Washington, D.C. One of the best barometers for tax reform should be U.S. small-cap stocks, since they stand to benefit the most from a reduction in tax rates. Small-cap stocks peaked in early October and have underperformed other equity classes, even as legislative progress is being made on the tax plan. Recent U.S. gross domestic product (GDP) growth estimates also have been little changed by the anticipation of tax reform.

Overall, risk markets have enjoyed a strong year as global growth has become more synchronized—with most of the relative growth acceleration coming from overseas. If federal tax reform does stall, it could create a reason for domestic equity markets to pull back some of the multiple expansion that we have witnessed in 2017. It also would likely lead to a slight decline in both interest rates and the U.S. dollar.

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