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Economics Group

Special Commentary

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Wrapping Up The Tax Package

Executive Summary

After a year of political rhetoric and numerous iterations, this week Congress will send a final tax package worth $1.5 trillion over 10 years to President Trump for his signature. The package, worked out by the House and Senate conference committee, lowers tax rates for individuals until 2025 and permanently reduces the top tax rate for corporate income. As in any major changes to tax policy, the details matter. In this report, we summarize the major provisions of the completed tax legislation and discuss the implications of those changes on economic growth.

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While several aspects of the individual tax code have changed, on net over our current forecast horizon, through the end of 2019, most individuals will receive a reduction in their tax liabilities, although the timing of the economic effects is not straightforward.[1,2] In our view, the tax cuts for individuals are more likely to provide a slight short-run bump in economic growth through stronger aggregate demand. Over time, however, the impact from this one-time increase will fade. While many of these cuts may be extended when the expiration date is eventually reached, the outcome is uncertain and a mix of extension/expiration is a very possible outcome, as occurred with the Bush tax cuts. On the other hand, lower corporate taxes are less likely to provide a short-run adrenaline boost to economic growth, but over the long-run this should boost capital formation at the margin, providing some support to labor productivity growth.

Individual Tax Code Changes

Tax Brackets

On the individual side of the tax code, the tax package keeps the number of tax brackets at seven but modifies the rates and income thresholds. The marginal rate on the top bracket is reduced to 37 percent and would kick in at income in excess of $500,000 for single filers and $600,000 for married filers (Figure 1). The tax brackets would be indexed for inflation using the chained Consumer Price Index (CPI), a slightly less generous measure of inflation than the current CPI-U (Figure 2). All of the individual tax rate reductions except for the inflation indexing provisions are set to expire after 2025. After 2025, the individual tax code would "snap back" to current tax rates. The effective date for the lower individual tax rates is January 1, 2018.

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Deductions and Tax Credits

One of the larger tax policy changes on the individual side is the standard deduction increase to $12,000 for single filers, $18,000 for heads of household and $24,000 for joint filers. However, the legislation also eliminates or limits several deductions, credits and exemptions, such as the personal exemption, the moving expense deduction (except for active duty military), the alimony deduction (effective in 2019) and the state and local deduction (SALT). In the end, SALT was limited rather than fully repealed as individuals are still able to deduct state and local taxes up to a total cap of $10,000 (not indexed for inflation) between property and income or sales taxes.

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[1] **Joint Committee on Taxation. (2017). Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act." JCX-67-17.**

[2] **United States Congress. (2017). Conference report to accompany H.R. 1: Joint Explanatory Statement of the Committee of Conference.**

Several deductions were kept in the final package including the charitable contribution deduction, the deductions for medical expenses (which was actually increased), the deduction for student loan interest, the deduction for educator expenses and the exemption for private activity bonds (PABs). Just like the tax bracket changes, these changes would revert back to current law after 2025.

Child/Family Tax Credits

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Mortgage Interest Deduction

The final legislation caps the mortgage interest deduction at $750,000 of debt (down from $1 million under current law) and eliminates the deduction for home equity debt.

Estate Tax

The final legislation keeps the estate tax but doubles the exemption to $10.98 million, indexed to inflation.

Figure 1

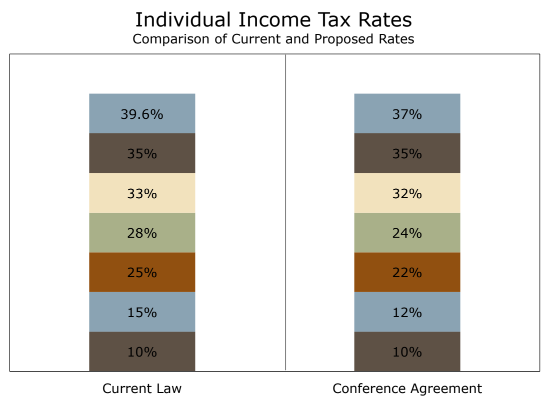
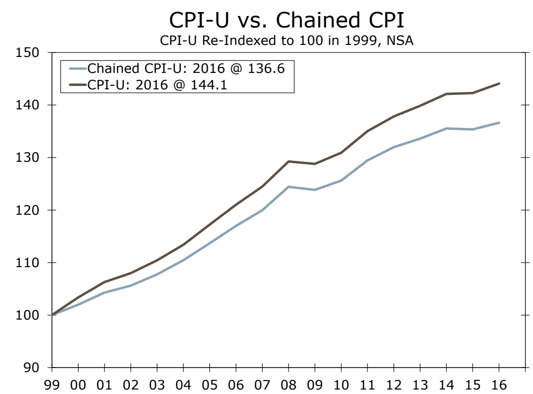


Figure 2



Source: Joint Committee on Taxation, CBO, IRS, U.S. Department of Labor and Wells Fargo Securities

Retirement Accounts/Investment Provisions

The legislation limits the ability of individuals to re-characterize contributions made under traditional individual retirement accounts (IRAs) to Roth IRAs. In addition, as much as $10,000 can be withdrawn annually from section 529 education saving accounts for tuition at elementary and secondary public, private and religious schools.

Pass-Through Income

Under the compromise between the House and Senate, the final legislation allows a deduction of 20 percent of qualified business income from total income beginning in 2018.

Under the compromise between the House and Senate, the final legislation allows a deduction of 20 percent of qualified business income from total income beginning in 2018, limited to either 50 percent of the W-2 wages paid or 25 percent of W-2 wages plus 2.5 percent of the cost of tangible, depreciable property. The legislation also excludes some “specific service activities” such as health, law and accounting businesses from being used to take advantage of this provision for anti-abuse reasons. The deduction would only be fully available for service businesses with income of $157,500 or less for individuals or $315,000 or less for joint filers and would phase out for incomes greater than those thresholds. Dividends from cooperatives and real estate investment trusts (REITs) along with income from publicly traded partnerships would be deductible. Agricultural and horticultural cooperatives and trusts could qualify for part of the deduction. This pass-through deduction expires on December 31, 2025.

Individual Alternative Minimum Tax

The legislation preserves the AMT for individuals but with a higher ($109,400) exemption amount and raises the phase-out threshold to $1 million for joint filers.

Affordable Care Act Individual Mandate

The legislation enacts a de facto repeal of the individual mandate in the Affordable Care Act by reducing the penalty for not having health insurance to $0. This provision would take effect in 2019.

Corporate Tax Code Changes

Corporate Tax Brackets

Under the final plan, the corporate income tax rate is reduced to a flat rate of 21 percent. The corporate AMT is repealed.

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Business Expensing

The legislation allows for full expensing of short-lived capital investment (e.g., equipment and machinery) for five years and then phases out the provision over the subsequent five years.

Tax Treatment of Interest

The legislation caps the net interest deduction at 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) for the first four years. Thereafter, the cap is further limited to 30 percent of earnings before interest and taxes (EBIT). Interest amounts greater than 30 percent could be carried forward into future tax years.

Net Operating Loss Provisions

The legislation eliminates net operating loss carrybacks while providing indefinite net operating loss carryforwards, limited to 80 percent of taxable income.

Other Business Credits and Deductions

The final package makes changes to a slew of other business credits/deductions that are in many cases much more niche in nature. Some of the changes to the largest other credits/deductions include the elimination of the deduction for income attributable to domestic production activities, the amortization of some research and experimental expenditures and limitations on the deductibility of FDIC premiums.

International Taxation

Companies headquartered in the United States would in many instances no longer need to pay taxes on profits earned abroad. However, this new system provides an incentive for companies to classify as much income as possible as foreign-sourced. To combat this, the legislation developed a series of anti-abuse and base erosion measures. Income from passive sources, for example, would be subject to a 10 percent tax. A 5 percent tax that eventually increases to 12.5 percent after 2025 would also kick-in when deductible payments to foreign related parties breach a certain threshold.

Deemed Repatriation

The package imposes a one-time deemed repatriation tax on U.S. corporations' offshore earnings. The rate for cash and other liquid assets would be 15.5 percent, while it would be 8 percent for other earnings. The cash position of an entity consists of all cash, net accounts receivables, and the fair market value of similarly liquid assets, including personal property that is actively traded on an established financial market, government securities, certificates of deposit, commercial paper, foreign currency and short-term obligations. In addition, the Secretary of the Treasury may identify other assets that are included. The tax liability could be paid in equal installments over eight years.

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Economic Effect: Timing of Effects Uncertain

As we have pointed out, there could be greater growth effects in the early years and more gradual growth in the later years.

The Joint Committee on Taxation (JCT) as of this writing has not produced an updated economic analysis of the House and Senate conference report. That said, the conference report is not materially different from the individually passed House and Senate bills, which were shown to increase the level of GDP over the next 10 years by 0.7 and 0.8 percent on average, respectively.[3,4] As we have pointed out, there could be greater growth effects in the early years and more gradual growth in the later years given that many of the individual provisions are set to expire, full expensing on the corporate side is eventually phased-out and the "crowding out" effect from the growing national debt is likely to grow in scale over time. That said, if we smooth out the JCT's estimate over the next decade, the average annual change in GDP growth would be +0.14 percentage points per year, which is just slightly below our estimate of an additional +0.15 percentage points per year on GDP growth.[5]

Relative to current law, the conference committee's legislation reduces federal tax revenues by approximately $170 billion in calendar year 2018 and $275 billion in calendar year 2019, amounting to roughly 0.8 and 1.3 percent of GDP, respectively (Figure 4). The individual tax cuts in particular ramp up significantly in calendar year 2019. As we have highlighted previously, the larger economic effect from the individual tax cuts may be felt more in 2019 than 2018 as some of the changes, such as the doubling of the standard deduction and more generous child tax credit, are felt when middle-income taxpayers file their 2018 taxes in the first few months of 2019.

Figure 3

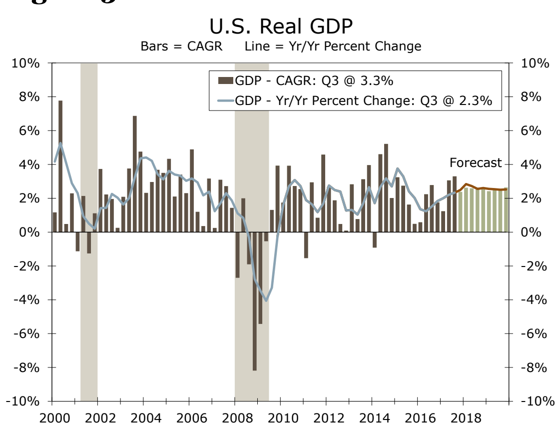
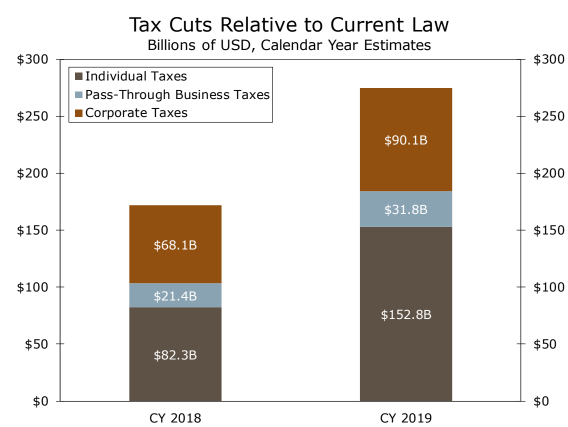


Figure 4



Source: U.S. Department of Commerce, Joint Committee on Taxation and Wells Fargo Securities

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In trying to quantify some of the longer-run growth effects, we turn to the Tax Foundation, a leading think tank on the tax policy front whose analysis has been at the forefront of the tax debate. Generally speaking, its models use assumptions that produce a larger economic growth effect from a deficit-financed tax cut than the estimates produced by the Joint Committee on Taxation or other

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[3] Joint Committee on Taxation. (2017). Macroeconomic Analysis of the "Tax Cuts and Jobs Act" as Passed by the House of Representatives on November 16, 2017. JCX-66-17.

[4] Joint Committee on Taxation. (2017). Macroeconomic Analysis of the "Tax Cuts and Jobs Act" as Ordered Reported by the Senate Committee on Finance on November 16, 2017. JCX-61-17.

[5] Brown, M.A., Pugliese, M. and Kinnaman, A. (2017). Understanding the Senate Tax Plan's Dynamic Score. Wells Fargo Economics Group.

leading think tanks. In our view, the Tax Foundation's analysis provides a loose upper bound on the potential growth effects from the conference committee's proposed legislation. According to the Tax Foundation's Taxes and Growth Model, the plan would lead to a 1.7 percent increase in GDP over the long-run and create an additional 339,000 full-time equivalent jobs.[6] In addition, the Tax Foundation model believes economic growth would be about 0.44 percentage points higher in 2018 than the baseline. Beyond the first year, average annual GDP growth would be about 0.29 percentage points higher per year over the remainder of the decade. Dividing their estimate of 339,000 new jobs by 120 months over the next decade would yield average job growth that is approximately 3,000 jobs per month higher.

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This supports our view that the legislation is likely to lead to more front-loaded growth in the next couple years and more gradual growth in the out years than a simple average of the entire period would suggest. Furthermore, given that we view this model as more of an upper bound than as median result, we believe that this supports our base case that the tax package will provide just a few tenths of a percentage point boost to economic growth over our forecast horizon.

[6] **Tax Foundation. (2017). Preliminary Details and Analysis of the Tax Cuts and Jobs Act. Special Report No. 241.**

APPENDIX

Individual Tax Rates and Brackets							
Current Law (2017)				Tax Cuts and Jobs Act: Conference Agreement (2018)			
Rate	Single	Married	Head of Household	Rate	Single	Married	Head of Household
10.0%	>$0	>$0	>$0	**10.0%**	>$0	>$0	>$0
15.0%	>$9,325	>$18,650	>$13,350	**12.0%**	>$9,525	>$19,050	>$13,600
25.0%	>$37,950	>$75,900	>$50,800	**22.0%**	>$38,700	>$77,400	>$51,800
28.0%	>$91,900	>$153,100	>$131,200	**24.0%**	>$82,500	>$165,000	>$82,500
33.0%	>$191,650	>$233,350	>$212,500	**32.0%**	>$157,500	>$315,000	>$157,500
35.0%	>$416,700	>$416,700	>$416,700	**35.0%**	>$200,000	>$400,000	>$200,000
39.6%	>$418,400	>$470,700	>$444,550	**37.0%**	>$500,000	>$600,000	>$500,000

Other Provisions: Individual Tax Cuts				
Indexing Provisions	Uses the chained CPI measure of inflation.			
Standard Deduction		Single	Married	Head of Household
	Current Law	$6,350	$12,700	$9,350
	Proposal	$12,000	$24,000	$18,000
Itemized Deductions	Retains the mortgage interest deduction but lowers the cap to $750,000 of mortgage debt and suspends the deduction for $100,000 in home equity debt. Maintains the state and local tax (SALT) deduction but caps deductions at $10,000 for property taxes and income or sales taxes. Retains the medical expense deduction and lowers the threshold to 7.5 percent of income for the 2017 and 2018 tax years. Reverts back to the current 10 percent threshold beginning in the 2019 tax year. Retains the chartiable deduction.			
Other Deductions and Exclusions	Retains educator expense deduction and graduate school tuition waivers. Elminates the moving expense deduction except for active military members.			
Family Tax Credits	Increases the child tax credit (CTC) to $2,000 and increases the refundable portion of the CTC from $1,000 to $1,400 and increases the phaseout threshold. New temporary $500 nonrefundable credit for dependents other than children, changes expire after 2025. Preserves the adoption credit.			
Affordable Care Act Individual Mandate	Effectively repeals the individual mandate by eliminating tax penalties for those that do not buy health insurance.			
Alternative Minimum Tax	Maintains the individual AMT. Increases the exemption to $109,400 for joint filers and increases the phase out threshold to $500,000 for single filers and $1 million for joint filers.			
Estate Tax	Preserves the estate tax but doubles the exemption to $10.98 million from $5.49 million in 2018.			
Retirement Accounts	Limits recharacterization of contributions to certain retirement accounts. Individuals are no longer able to re-characterize contributions made under a traditional IRA to a Roth			
Pass-Through Rate	New 20 percent rate for pass-through business income, subject to anti-abuse rules (greater of 50 percent of wage income or 25 percent of wage income and 2.5 percent of cost of tangible depreciating property for qualifying businesses).			

Source: U.S. House of Representatives Committee On Ways and Means, U.S. Senate Committee on Finance, U.S. Senate Committee on the Budget, Joint Committee on Taxation, Bloomberg Government, Tax Foundation, IRS and Wells Fargo Securities

Corporate Tax Cuts	
Corporate Tax Rate	Lowers corporate income tax rate to 21 percent from 35 percent, effective in 2018.
Capital Investment	Full expensing of short-lived capital investments for 5 years.
Tax Treatment of Interest	Net interest expense deductibility limited to 30 percent of EBITDA for 4 years, and 30 percent of EBIT after the initial 4 years.
Net Operating Loss Provisions (NOLs)	NOLs can be carried forward indefinitely, restricts deduction to 80 percent of current year taxable income.
Business Credits and Deductions	Retains or modifies many tax credits including those for orphan drugs, real estate rehabilitation and contributions for capital.
Alternative Minimum Tax	Eliminates the corporate AMT.
International Income	Moves to a territorial tax system, dividends and profits not subject to repatriation taxes. Creates a new base erosion anti-abuse tax at 5 percent of modified taxable income, equal to regular tax liability in year one, 10 percent through 2025 and 12.5 percent after 2025.
Deemed Repatriation	Deferred foreign profits to be taxed at a 15.5 percent rate for cash and cash equivalents, 8 percent for reinvested foreign earnings.

Other Tax Policy Changes	
Exempt Organizations	Creates an excise tax of 1.4 percent on net investment income of private colleges and universities with endowments of at least $500,000 per full-time student and at least 50 percent of students located in the U.S.
Bond Reforms	Interest income on private activity bonds remains tax exempt, interest income on advance refunding bonds no longer tax exempt if issued after 2017 . Prevents the issuance of new tax credit bonds.
Energy Credits	Maintains most energy credits including the electric vehicle purchase credit.
Permanence	Individual tax cuts end on December 31, 2025, while corporate tax cuts mostly remain permanent.

Source: U.S. House of Representatives Committee On Ways and Means, U.S. Senate Committee on Finance, U.S. Senate Committee on the Budget, Joint Committee on Taxation, Bloomberg Government, Tax Foundation, IRS and Wells Fargo Securities

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