SPECIAL REPORT

TD Economics

February 27, 2017

# ANSWERING THE BIG QUESTIONS ON U.S. TAX REFORM

Comprehensive tax reform has been a consistent policy goal of the Republican Congress and an important part of President Trump's election platform. The timing and scope of tax reform are still unknown, but there is every indication that the intention remains in place. This note addresses the top questions currently being asked by our clients.

**Questions & Answers:**

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### What are the key changes to the tax system currently being contemplated?

At a high level, there is broad agreement among Republicans on the fundamental principles for tax reform. Senate Finance Committee Chair, Orrin Hatch, outlined these principles in a recent speech:

- pro-growth
- comprehensive (address both the individual and business tax systems)
- simple (reduce the number of special interest credits, deductions and tax brackets)
- competitive (reduce corporate income tax rates and move to a territorial system)

Congressional Republicans also expressed a desire to reform or repeal the estate tax and to ensure that tax reform is revenue neutral and does not lead to long-term increases in deficits.

The key features of the two leading Republican plans – the Trump campaign platform and the House Republican (GOP) Blueprint – are outlined in Table 1. On personal income taxes, the core reforms proposed by the House plan and President Trump are to lower marginal personal income tax rates, broaden the tax base and simplify the system by reducing the number of tax brackets, deductions and exemptions.[1] Both plans would collapse the number of brackets from the current seven to three, with rates of 12%, 25% and 33%, and raise the standard deduction (although to different degrees), while eliminating personal exemptions.

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**Table 1: Key Features of Trump Campaign & House GOP Tax Reform Plans**

| | Current System | | House GOP | | Trump |
|---|---|---|---|---|---|
| **Personal income tax changes** | | | | | |
| **Tax rates & thresholds* (single filers)** | **Rate** | **Income over** | **Rate** | **Income over** | |
| Lowest income threshold= standard deduction + personal exemptions | 10% | $10,350 | 12% | $12,000 | $15,000 |
| | 15% | $19,625 | | | |
| | 25% | $48,000 | 25% | $49,650 | $52,500 |
| | 28% | $101,500 | | | |
| | 33% | $200,500 | 33% | $202,150 | $127,500 |
| | 35% | $413,351 | | | |
| | 39.6% | $415,051 | | | |
| **Investments** | | | | | |
| Capital gains & qualified dividends | 0%, 15%, 20% | | 6%, 12.5%, 16.5% | | 0%, 15%, 20% |
| Interest income | as ordinary income | | 6%, 12.5%, 16.5% | | unknown |
| Carried interest | as capital gains | | unknown | | as ordinary income |
| Net investment income surtax (>$200K) | 3.8% | | eliminate | | eliminate |
| **Estate tax** | 40% > $5.49 M | | eliminate | | eliminate; tax capital gains > $10M |
| **Corporate income tax changes** | | | | | |
| **Corporate tax rate** | 35% | | 20% | | 15% |
| **Pass-through business tax rate** | taxed at individual level | | 25% (max) | | 15% |
| **Tax on unrepatriated foreign earnings**** | na | | 8.75%, 3.5% | | 10%, 4% |
| **Treatment on investment spending** | depreciate | | full expensing | | choose |
| **Interest expense deduction** | deductible | | eliminate | | choose |
| **Marginal effective tax rate on new investment - corporate, pass-through** | 22%, 18.9% | | 8.8%, 2.5% | | 9.5%, 2.6% |
| *Both plans would eliminate the personal and corporate alternative minimum tax* | | | | | |

Source: Tax Policy Center. *Adjusted Gross Income. ** Cash, other earnings.

*Note: The personal income thresholds above apply only to taxfilers who claim the standard deduction. For the 30% of filers who itemize deductions, the thresholds would be lowered by the standard deduction.*

Both plans would also eliminate the 3.8% net investment income surtax that is levied for those earning more than $200,000 (single) / $250,000 (couple) that was brought in to help fund the Affordable Care Act. This change is likely to go through before other changes, as part of the planned reforms to healthcare legislation this year.

Congress is expected to take the lead in crafting the details of tax reform, and therefore the House plan is generally viewed as the starting point for tax reform by most analysts. President Trump has demonstrated a willingness to compromise in favor of the House Republican's view. He did so during the campaign by adjusting his tax brackets so they matched the House plan.

### Are there some key distinctions between the two proposals?

One key difference between the plans is the treatment of investment income. The GOP plan proposed a 50% exclusion on capital gains, dividends and interest income. This would effectively tax investment income at half the rate of wage income. Trump's plan is largely silent on investment income, but would tax carried interest as ordinary income (a popular way of compensating executives in private equity and hedge funds to minimize tax). In any event, common ground here would likely not be difficult to achieve.

A greater divide is apparent on the corporate side. Although both plans propose substantial reductions to the statutory rate of 35% (to 20% under the House plan and 15%

under Trump's proposal), the House GOP plan proposes a more substantial shift in the way corporate income is taxed. Under current law, the U.S. taxes income earned domestically as well as the income of U.S. residents earned abroad. Under the new system, corporations would no longer pay tax on foreign-sourced income (either repatriated overseas earnings or income from exports), and would only pay tax on the revenue generated from the sales of goods and services consumed in the U.S. Accordingly, businesses could not deduct the cost of imported goods and services when calculating income for tax purposes. The changes proposed by the GOP blueprint would transform the corporate income tax into a "destination-based cash-flow tax" (abbreviated as DBCFT).

**What exactly is a "destination based cash flow tax" and why is it so controversial?**

There are two components to this corporate tax reform, broken down by "cash flow" and "destination based." Cash flow reflects the fact that businesses will be taxed on the flow of cash entering the business minus cash leaving the business. Practically what this means is that businesses can fully deduct from tax all costs of production, including wages and salaries and capital investment. The main change to the tax system is that businesses would no longer depreciate capital investments, but would expense them fully in the year of purchase. At the same time, businesses could no longer deduct interest expenses from taxable income.

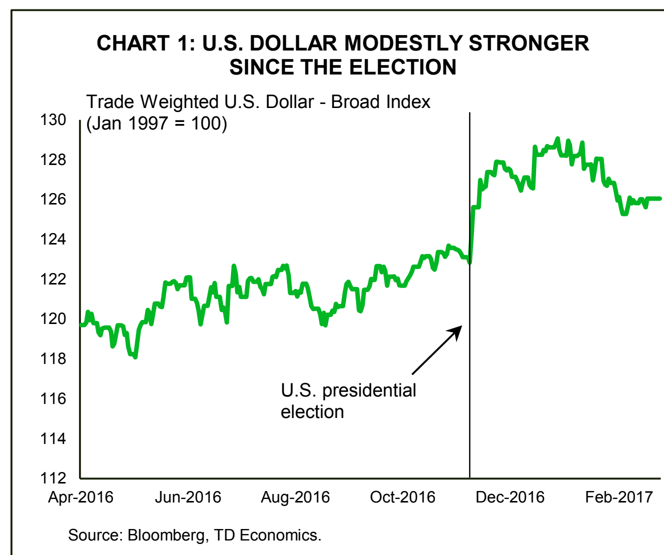
The "destination based" element refers to the fact that taxes are paid only on goods and services consumed in the U.S. Imports are therefore included, but exports are not. This part of the plan will require "border adjustments" – taxing imports at the border and crediting exports. Since the U.S. currently imports more than it exports, border adjustments represent a significant broadening of the tax base. Revenue generated from border adjustments offsets over 60% of the cost of the tax rate reduction and elimination of the alternative minimum tax over the first ten years of the proposal. This makes it a critical component to reducing the costs of the House plan.

Border adjustments are the most controversial part of the plan. They seemingly advantage companies with a high degree of export revenue, and disadvantage firms with a higher import dependence on inputs. Economists who support the proposal argue that this impact would be offset by an appreciation in the U.S. dollar. A stronger U.S. dollar will lower the cost of imports, and raise the price of exports, such that the after-tax income between companies that export heavily versus those that import would be equalized. However, the dollar would need to appreciate by 25% for this to strictly hold true. Most analysts (including ourselves) deem this a remote possibility, or an adjustment that would take several years to transpire. To the extent that the dollar does not increase by the full amount, the higher price of imports is likely to be passed onto consumers. This has formed a key source of opposition among interest groups, like retailers and Republican Senators.

So far this year, the trade-weighted U.S. dollar has depreciated slightly relatively to other currencies, and has appreciated only 2.6% since the election (see Chart 1). This leads us to conclude that financial market participants are currently discounting the possibility of a border adjustment tax (BAT) coming into existence. In fact, a recent news report indicated that Goldman Sachs is putting the odds of a BAT at just 20%. Others, like Bank Credit Analyst, place the odds higher at 50%. Regardless, there is significant upside risk to the greenback should Congress succeed in pushing through a border adjustment tax.

One of the reasons for the discounted odds is that the tax plan appears to run afoul of World Trade Organization (WTO) rules and could trigger international challenges and potential retaliatory tariffs. While the WTO allows border adjustments in the context of value added taxes, these are considered indirect taxes. In the context of the DBCFT, the deduction for wages and salaries in combination with an import tax could be considered a direct export subsidy.

Despite the controversy caused by border adjustments, the GOP's plan would remove many distortions in the



current U.S. international tax system. It would no longer encourage overseas production to skirt taxes because all production for domestic consumption would be taxable. It would also eliminate any incentive for corporate inversion transactions, because the amount of tax paid would not depend on where it was incorporated or where the product or service was produced, but rather where the good or service is consumed.

### Who will win and lose from the GOP's corporate tax plan?

Exchange rate adjustment may mitigate some of the differential impact on exporters versus importers, but there are still likely to be winners and losers from the proposal, at least in the near term. Industries with the highest imported content will be the most adversely affected. At the top of this list are retailers and oil refiners. Imports account for more than 20% of the value of output for apparel and textiles, oil and gas extraction, electronics and electrical equipment, furniture, and motor vehicles and parts industries.

On the other side of the ledger, industries that export a large share of their output will be major beneficiaries of the reform. In cases where their domestic costs exceed their domestic sales, they may actually receive tax rebates from the government. This appears likely for businesses in the aerospace industry whose receipts are mostly from exports.

Given the highly integrated nature of North American supply chains across borders, the Canadian economy will feel the impact of the border adjustment. A recent study by the C.D. Howe Institute finds that the DBCFT would negatively affect firms level decisions to source from Canada, with the tax leading businesses to replace Canadian suppliers with American ones over time.

Canada's exports to the U.S. are heavily weighted to intermediate inputs, including raw materials, basic fabricated materials, and manufactured inputs such as auto parts. The authors find Canada's worst-hit industries in terms of reduced exports would include: autos, fossil fuels, and machinery and equipment. Overall the C.D. Howe study finds that as proposed, the plan would reduce the level of Canada's GDP by one percent over the next five years.

Ultimately, there are some natural economic limitations that would transpire to restrain the negative impact. For instance, it takes time to find domestic suppliers to accommodate production needs and build out the appropriate capacity. With limited excess supply, American production costs would be pressured higher, including wages. This, in combination with currency adjustment, would mute the domestic tax advantage. The bottom line is that there are many moving parts within this equation and the general sense is that a U.S. destination tax would be net negative for Canadian producers, but not the "sky-will-fall" outcome that some predict.

### How much will tax reform cost?

Table 2 contains the leading cost estimates for the two plans according to leading policy think tanks: the Tax Policy Center and the Tax Foundation. By either estimate, the Trump plan is orders of magnitude more expensive than the House plan, costing around $6 trillion on a static basis. The sheer cost of the Trump plan is another reason why the House plan is viewed as a more realistic starting point. For the GOP plan, the estimates range from $3.1 trillion to $2.4 trillion on a static basis.

In addition to the static estimates, both think tanks make dynamic estimates that allow the growth augmenting elements of the plan to feedback to tax revenues. Once higher economic growth is factored in, the cost of the reforms will fall relative to an economic baseline that assumed the status quo. However, there is a considerably higher degree of uncertainty around how much the tax plans will influence the economy in both the near and long-term (see What is the potential economic impact of tax reform?). As these estimates rely on different model assumptions about the

**Table 2: Revenue Impact of Tax Proposals 2016-2026**
*(US$, trillions)*

| | Trump | | House GOP | |
|---|---|---|---|---|
| | TPC | Tax Found. | TPC | Tax Found. |
| **Static Revenue Impact:** | | | | |
| Personal tax cuts | -$3.3 | -$3.7 | -$2.0 | -$1.0 |
| Corporate tax cuts | -$2.6 | -$1.9 | -$0.9 | -$1.2 |
| **Total* Static Revenue Impact:** | -$6.2 | -$5.9 | -$3.1 | -$2.4 |
| **Total Dynamic Revenue Impact (after macro feedback):** | -$6.0 | -$3.9 | -$2.5 | -$0.2 |

**Totals do not add due to smaller measures not shown*
Source: Tax Policy Center and the Tax Foundation

responsiveness to individuals and businesses to changes in the tax rates, there is an even greater divergence in the estimated costs.

In neither case do the tax-cut plans totally "pay for themselves." Nonetheless, the dynamic impacts under the Tax Foundation's model results in the GOP plan coming close enough that the revenue losses could more easily be offset through spending restraint. Both organizations see the House plan as having larger dynamic effects on the economy, i.e. it is more growth enhancing.

Recent comments by Treasury Secretary Steven Mnuchin suggest that the administration will do its own dynamic scoring of the plan, which he stated would likely presume greater growth-enhancing elements than the Congressional Budget Office or Joint Committee on Taxation. Mnuchin noted that the Trump administration is aiming for economic growth above 3%. With stronger economic growth assumptions, the plan is more likely to appear revenue neutral. However, this creates risk for the administration should growth disappoint their rosy expectations. Moreover, it remains to be seen how financial markets would respond to the deficit projections from the administration, especially if they diverge considerably from those of most other analysts.

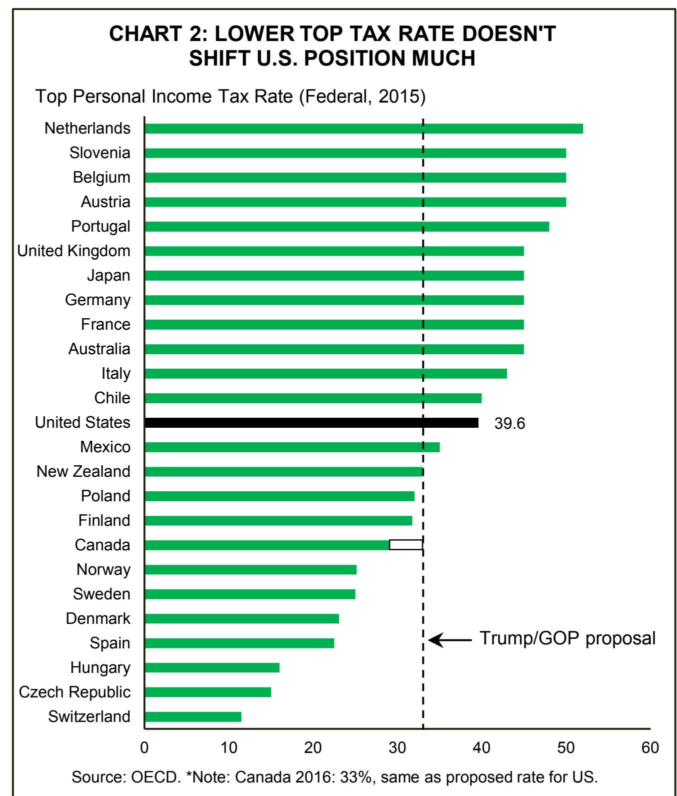
Achieving greater than 3% growth on a sustainable basis will be a tall order for the American economy. This is largely due to demographics. Over the next decade the adult population of the United States (16+) is set to grow by over 24 million people (0.9% annually). However, the population of people over 60 will grow by over 19 million (2.5% annually), while the population below 60 will only grow by 5 million (just 0.2% annually).

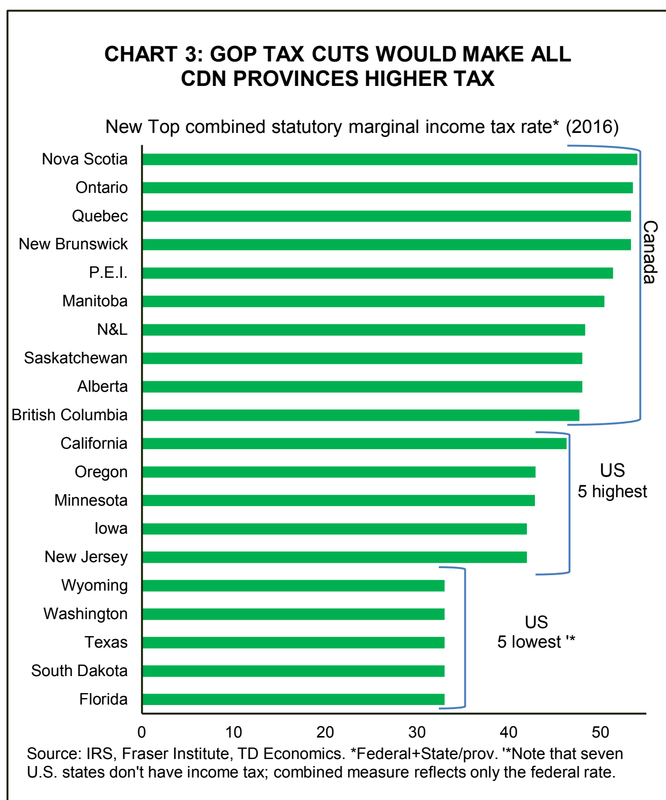
Due to population aging, growth in the U.S. labor force is likely to fall to just 0.5%, a full percentage point below its historical average rate of 1.5%. Moreover, this assumes current rates of immigration. If immigration is cut back, labor force growth will be even slower than this. With this backdrop in place, achieving 3% annual growth would require labor productivity to not only rise above the rate over the past decade, but to push to highs rarely seen historically over a sustained period. While lower tax rates on investment should help to raise trend productivity, it is not plausible to expect such a rapid reversal in the absence of rapid technological change.

### How competitive would U.S. rates become?

The Republican plans would improve the competitive position of the U.S. tax system among its OECD peers. On the personal side, the decline in the top marginal rate would move the U.S. from close to 40% to 33%. This does not move the needle much in a ranking of OECD countries' top marginal rate at the Federal level (see Chart 2), although it would bring the rate below Mexico. Relative to Canada, the Republican plans would make U.S. states significantly more competitive than under the current structure (see Chart 3, next page). At a 33% top marginal PIT rate at the federal level, all U.S. states would be lower compared to Canadian provinces (assuming no change to state or provincial tax rates).

On the corporate side, the proposed lower corporate income tax (CIT) rates would significantly improve the competitive position of the U.S. corporate tax system. Competitiveness concerns have lead many OECD countries to lower their corporate income tax rates in recent years (see chart), while the U.S. has remained steady. The average statutory rate in the OECD is 25.5%, while politics have stymied repeated attempts to lower the U.S. rate from 35%.[2] A move to a 20% CIT rate would significantly improve the U.S. position.





Source: IRS, Fraser Institute, TD Economics. *Federal+State/prov. '*Note that seven U.S. states don't have income tax; combined measure reflects only the federal rate.

### Who benefits from the proposed personal tax cuts?

Under both Republican plans, all income groups will receive a tax cut. However, higher income earners will reap the majority of benefits from the proposed changes, whether in dollar or percentage terms. The gains are particularly large for the top 1% and 0.1% brackets, in part due to the elimination of healthcare surtaxes, estate taxes and the alternative minimum tax (see Table 3). The lowest income taxpayers' after-tax income would increase between $50 and $110 per year on average under the Republican tax reform plan, and a middle income taxpayer's after-tax income would increase between $260-1,010. The top 0.1% of income earners' after tax income would rise between $1 million and $1.3 million.

**Table 3: Average Federal Tax Change by Income level, 2017 ($)**

| Personal Income Quintiles | | Trump | House GOP |
|---|---|---|---|
| Lowest | | -$110 | -$50 |
| Second | $24,800 | -$400 | -$120 |
| Middle | $48,400 | -$1,010 | -$260 |
| Fourth | $83,300 | -$2,030 | -$410 |
| Top | $143,100 | -$16,660 | -$11,760 |
| Average | | -$2,940 | -$1,810 |
| Top 1% | $699,000 | -$214,690 | -$212,660 |
| Top 0.1% | $3,750,000 | -$1,066,460 | -$1,262,530 |

*Note: Dollar amounts indicate breaks between income quintiles in 2016 dollars.*

Source: Tax Policy Center, TD Economics.

### What is the potential economic impact of tax reform?

In the short-run tax cuts would provide a boost to aggregate demand by raising the disposable income of households and businesses. The increase in GDP for every dollar in tax cuts is called a fiscal multiplier. In the literature reviewed by the Congressional Budget Office, fiscal multipliers were found to be higher for personal income tax cuts than corporate ones (see Table 4). However, near-term multipliers from personal income tax cuts differ by income level. Lower income households have a higher propensity to consume out of an additional dollar of income than higher income households who are likely to save a greater portion of any income gain. Therefore, tax cuts that largely benefit higher income households have a less stimulative effect on the economy in the short run.

In addition, tax cuts tend to provide a larger benefit to the economy when it is operating significantly below potential, and there are idle resources to put to use. This however, does not describe the current state of the American economy. In the current environment, additional spending may speed up the move to full employment, but would soon put upward pressure on wages and inflation with a smaller impact on GDP growth.

The long-term impact of the tax cuts depends on their impact on the economy's productive potential. All else constant, tax reform that shifts the burden of taxation from investment to consumption should, over time, raise the level of investment, thereby lifting productivity and economic growth. Indeed, most of the anticipated gains from the GOP plan come through this channel. The House GOP plan implies a reduction in the marginal effective tax rate on new investment from 22% currently to just 6.3% according to the Tax Policy Center. At the same time, lower marginal personal tax rates should result in greater labor supply, although this is likely to be a much smaller contributor to potentially faster growth.

While the channels through which tax reform will impact the economy are relatively clear, the magnitude of their impact is much less certain. There are a wide range of impact estimates in the economic literature dependent on the

| Table 4: CBO Multiplier Estimates | Low | High |
|---|---|---|
| Federal Govt. purchases | 0.5 | 2.5 |
| Transfers to State/local govt. for infrastructure | 0.4 | 2.2 |
| 2-Yr tax cuts - low & middle income | 0.3 | 1.5 |
| 1-Yr tax cut - higher income | 0.1 | 0.6 |
| Corporate tax provisions (affecting cash flow) | 0 | 0.4 |

Source: Congressional Budget Office (CBO).
Note: The estimates above were produced for CBO's analysis of the American Recovery and Reinvestment Act of 2009.

model used and the time period over which it is estimated or calibrated. In terms of the leading analysis of the GOP proposal, the impact on the economy over the next decade is 9.1% higher real GDP for the Tax Foundation and 1% higher for the Tax Policy Center. That would imply an average lift to economic growth of roughly 0.1% to 0.9% per year. This assumes that enough savings are found elsewhere to prevent a rising deficit from swamping the economic gains.

**When are tax policies likely to be implemented?**

Congressional leaders have indicated a commitment to get tax reform done in 2017, and it is a key White House priority as well. The President has indicated that details on a "phenomenal" tax package are coming within a couple of weeks, but this announcement is likely to be a high level re-emphasis of commitments and general principles. More relevant, House Speaker Paul Ryan has indicated that Congress won't address tax reform until after the spring budget, which will address repealing and replacing the Affordable Care Act. Chair of the House Ways and Means Committee, Brady, has said that he plans to put a tax bill in front of the House before the summer break in August. Tax reform is therefore unlikely to be worked out in detail until at least the second half of the year.

That is only one step in the process of implementation, however. It would still need to pass the Senate (before being signed by the President). Republican proposals could face difficulty passing the Senate where Republicans hold a slim 52 seat majority. Without a filibuster-proof 60 seats, the legislation would either have to gain bi-partisan support or pass via budget reconciliation, which allows proposals to advance with just 51 votes. However, budget reconciliation will pose its own constraints on the bill, the foremost of which is the requirement that it be budget neutral beyond 10 years. This will likely result in some watering down of the plan.

Due to the scope and complexity of the proposals at hand, caution is warranted on tax reform expectations. In particular, the divide between House and Senate Republicans regarding a border adjustment tax may prove too tall an order for reconciliation. However, the absence of a broader tax base in combination with the proposed reduction in rates will leave a gaping tax revenue hole that will also not pass the scrutiny of Republicans. One potential outcome is that dynamic scoring results in rather optimistic GDP growth assumptions, in the order of 3% or more. However, this is unlikely to pass the scrutiny of financial markets, risking a counterproductive aggressive rise in yields.

The bottom line is that tax reform is easier said than done. Tax cuts are easy, but expensive. Revenue-neutral reforms may be beneficial over the long term, but create near-term losers that will oppose the change. Negatively affected groups will lobby Congress against reforms. The negotiation process will take time and is likely to be watered down from initial intentions. Under a best case scenario, tax reform is passed in late 2017, and while it could be made retroactive, the economic impact would likely not be felt until 2018. Looking at the 1986 Reagan tax reform period, it was 13 months from the time the House Ways and Means committee began "mark-up" tax reform legislation to the time President Reagan signed the bill.[3] Following that time line would mean tax reform would not be passed until mid-2018.

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## ENDNOTES

1 The GOP plan consolidates five basic family tax deductions and credits into a larger standard deduction and an enhanced child and dependent tax credit. Trump's plan eliminates the "head of household" category, which applies to single-earner and single-parent households, but offsets the impact with a new deduction for child and dependent care expenses and increase the earned income tax credit for working parents. The GOP plan eliminates all itemized deductions with the exception of the two most important ones – mortgage interest and charitable donations, while Trump's plan caps the total amount of itemized deductions at $100,000 ($200,000 for joint filers). ↑

2 Jane G. Gravelle. "International Corporate Tax Comparisons and Policy Implications." Congressional Research Service (January 6, 2014). https://fas.org/sgp/crs/misc/R41743.pdf ↑

3 "Understanding the Tax Reform Process." KPMG (December 5, 2016). https://home.kpmg.com/content/dam/kpmg/xx/pdf/2016/12/tnf-faq-on-tax-reform-final.pdf ↑

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