The US 2017 Tax Reform: Broad and Material

The unified *Tax Cuts and Jobs Act* outlines a wide array of tax changes that realigns the US corporate income tax burden with other developed economies (chart 1), lowers taxes on other business enterprises, overhauls the taxation of US corporations' worldwide income, and provides some personal tax relief. In its entirety, the legislation is notable on several counts, including the multiple intended and unintended consequences and the immediate implementation, on January 1, 2018, for most of its provisions. A high level summary of the changes is provided on pages 3–4.

The planned tax rate reductions are expensive. To offset this cost, finding a sufficient number of tax credits and deductions to either scale back or eliminate, given vested interests for each deduction, has proven difficult.

Shaping the final policy compromises is the reconciliation process to allow Senate passage of the legislation with a simple majority. This requires limiting the measures' net impact to a $1.5 trillion widening of the deficit from fiscal 2018 (FY18) to FY27[1]. The Joint Committee on Taxation (JCT) has confirmed compliance, estimating a net $1.456 trillion ten-year cost. The reconciliation process also requires no material widening of the federal deficit after FY27, which the Congressional Budget Office and the JCT affirm. To meet these restrictions, changes to personal, pass-through income and estate taxes will sunset after 2025, reverting to their pre-2018 form, unless extended. Permanent measures encompass: the corporate income tax (CIT) and international tax changes, the new PIT indexation measure and the effective removal of Obamacare's Individual Mandate that required citizens to obtain basic health insurance or pay a penalty.

The fiscal arithmetic indicates a net $136 billion revenue cost for this fiscal year (FY18), rising to $280 billion in FY19. Then, according to the JCT, the annual revenue costs gradually decline through FY26 before reversing to a net $33 revenue source in FY27, (table 1). For individuals and domestic business, the federal revenue cost of the ten-year tax relief totals $1.13 trillion and $0.65 trillion, respectively, but the total $1.78 trillion is offset by revenue inflows of $0.32 trillion from the international tax changes. Critical to the international tax offset are the anticipated receipts of $339 billion from the deemed repatriation of offshore earnings on which US tax is presently deferred.

The JCT's $1.456 billion net ten-year cost estimate does not include dynamic modelling to incorporate the fiscal consequences of the growth spurred by the tax reform. It has been argued that the boost to economic growth, employment and wages from the tax reform will dramatically reduce its net cost. The JCT, in its macroeconomic analysis of the Senate version of the *Act,* concluded that the net budgetary effects of the pick-up in growth would total $36 billion in FY19 (the first full fiscal year after implementation), $40 billion in FY20, and over the decade $0.4 trillion.

[1] US federal fiscal year 2018 ends September 30, 2018. All dollar amounts in US dollars. Personal tax changes are referenced in terms of a single filer.

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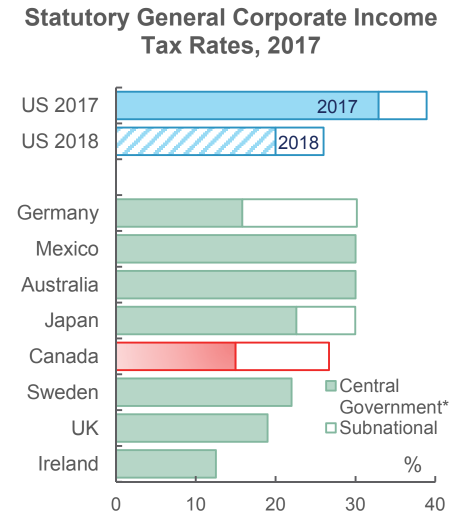
Chart 1



* Central government rates include surtaxes & any deduction for subnational taxes. Source: OECD.

Table 1

***The Tax Cuts and Jobs Act*: Budget Effects**

Fiscal Years, US$ billions

	18	19	20-22	23-27	18-27
Individual Taxes	-75	-189	-479	-383	**-1,127**
Business Taxes	-129	-134	-256	-134	**-654**
International Taxes	69	43	77	136	**324**
Net Total	**-136**	**-280**	**-658**	**-380**	**-1,456**

* Negative entry reduces revenues and widens deficit.
Source: Joint Committee on Taxation.

Near term, modelling by Scotiabank Economics indicates that the tax reform would lift US real GDP growth by 0.1 percentage points in 2018 and 0.2 percentage points in 2019, cumulating to the peak impact of almost 0.3 per cent on the level of real GDP in 2019. Limiting the positive impact of the tax reform on output is the US economy's present position at or near full employment and the anticipated monetary policy response to the stimulus. As a result, US economic growth is expected to slow towards its longer term potential rate of about 1.8% as the end of the decade approaches. Longer term, the tax reform is expected to boost the level of US real GDP 0.1 per cent higher than it otherwise would have been.

Increased business investment is expected to underpin the US growth response to the tax reform. The broad-based US upturn in business capital plans already under way should be reinforced by the tax bill raising after-tax business income, permanently lowering the CIT rate and introducing 100% expensing for machinery & equipment purchases over the next five years. In addition, corporations' deemed repatriation of overseas earnings is expected to result in some business capital re-entering the US, potentially available to be deployed, though we do not think this will directly contribute to higher investment. During the US repatriation experience in 2004 under the *Homeland Investment Act,* the impact was largely through increased shareholder payouts.

The rise in consumer spending from the personal tax reductions is likely to be muted. For households, most of the tax relief expires after 2025 and it is tilted towards high-income residents who typically have a lower marginal propensity to consume than more modest income households (chart 2).

A longtime Republican objective was to simplify the federal business and personal income tax frameworks. With this legislation, they are only partially successful. Progress includes eliminating the corporate AMT and doubling the standard deduction to curtail itemized deductions to a fraction of the individuals filing tax returns.

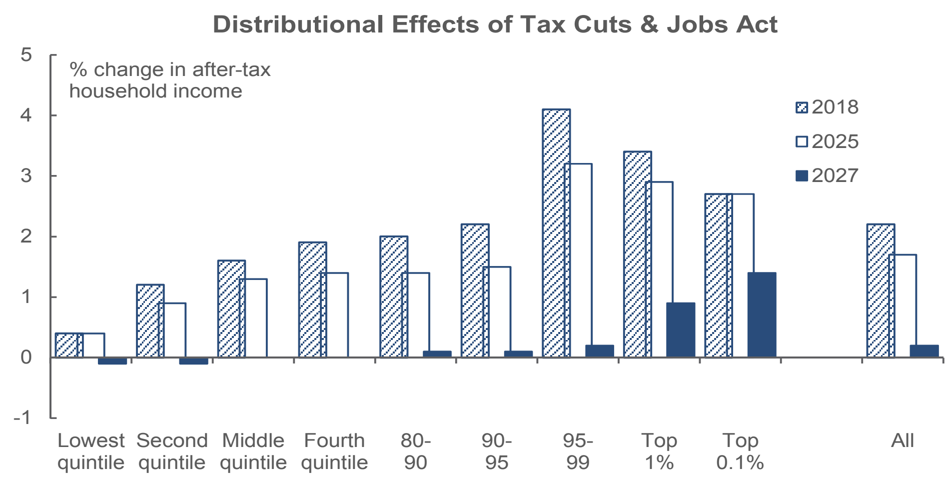
Washington has potentially kick started a cycle of significant tax adjustments. The US federal changes are likely to spur State and municipal tax adjustments as these governments each reassess their positions after the federal changes, including Washington's proposal to cap the existing *State and Local Tax Deduction.*

The US tax reform also may spur changes among other nations. For Canada, when the US economy picks up, Canadian real GDP typically witnesses approximately half of the US increase. Thus, the US tax package is expected to moderate slightly the slowing in growth forecast for Canada in 2018 and 2019, after Canadian real GDP surged 3.0% in 2017.

Longer-term, the US tax reform erodes Canada's prior advantage on statutory corporate income tax rates, leaving Canada's rate approximately equal to the US composite rate, though this depends somewhat on the State and Province that are being compared. Similarly, Canada's Marginal Effective Tax Rate on capital investment for manufacturing and services, that incorporates the CIT, sales tax on capital purchases, transfer taxes and other capital taxes, was previously lower and now will roughly pace the US rate (p.4, chart 3). Going forward, Canada has the choice of regaining its prior corporate tax advantage or building on other strengths to attract and retain business.

The tax reform without any offsetting adjustments, is expected to widen Washington's deficits from $666 billion (-3.4% of GDP) in FY17 to more than $900 billion (-4½% of GDP) in FY19, doubling the FY15 deficit of $439 billion (-2.4% of GDP). Net marketable borrowing in FY19 would broach $1 trillion again and the publicly held debt would post a new high at over 79% of GDP.

Chart 2



Source: Urban-Brookings Tax Policy Center.

The Unified Tax Cuts and Jobs Act — Selected Measures

Personal Income Tax *(PIT, JCT estimate of FY19 revenue impact in brackets)*

In contrast to the simpler three or four PIT brackets initially proposed, the unified bill retains the existing seven-bracket framework (side tables). The main adjustment is lowering the Senate's proposed top bracket rate of 38.5% to 37% to limit the tax increase for high-income filers in high-tax States *(-$135 billion)*.

PIT indexation would permanently shift from the traditional to the chained CPI, leading to smaller bracket increases and accelerating bracket creep that will benefit federal coffers in the future *(+$2 billion)*.

The current individual personal exemption of $4,150 for 2018 for a taxfiler, a spouse and each dependent is eliminated *(+$137 billion)*. To partially compensate, the *Child Tax Credit* is raised from $1,000 to $2,000, with $1,400 refundable and indexed, and the phase-out threshold for single filers is lifted from $75,000 to $200,000 *(-$68 billion)*. Families with a qualifying dependent other than a qualifying child would receive a $500 *Family Tax Credit*.

The Standard Deduction, currently $6,500 in 2018 for single filers as an alternative to itemized deductions, would be raised to $12,000 *(-$83 billion)*. The existing $1,300 add-on for disabled residents and Seniors will be retained.

Itemized deductions are limited to: charitable contributions; medical expenses, with the threshold trimmed to 7.5% of gross income for 2018 before reverting to 10%; the State and Local Tax Deduction now capped at $10,000 (unindexed) for property tax and a choice of income or sales tax paid[2]; and the home mortgage interest deduction, grandfathered for existing mortgages but the upper limit on new mortgages after December 14 is cut from $1 million to $750,000, and the interest deduction for home equity loans of up to $100,000 is eliminated.

For above-the-line deductions, retained are teachers' expenses, student loan interest and graduate student tuition waivers. Deductions for moving expenses (except for the military) and tax preparation costs are removed, and as of 2019, the alimony deduction is eliminated.

The Alternative Minimum Tax (AMT) is retained; the exemption for individuals is lifted from $55,400 to $70,300 and the phase-out threshold is elevated from $123,100 to $500,000 *(-$83 billion)*.

Table 2

Federal Personal Income Tax Rates, Single Payer

Taxable Income	Rate
Canada - 2017	
Taxable Income, C$000	**Rate**
up to $45.9	15
$45.9 - $91.8	20.5
$91.8 - $142.4	26
$142.4 - $202.8	29
$202.8+	33
US: Existing, 2018	
Taxable Income, US$000	**Rate**
up to $9.5	10
$9.5 - $38.7	15
$38.7 - $93.7	25
$93.7 - $194.5	28
$194.5 - $425	33
$425.0 - $426.7	35
$426.7+	39.6
US: Final Plan, 2018	
Taxable Income, US$000	**Rate**
up to $9.5	10
$9.5 - $38.7	12
$38.7 - $82.5	22
$82.5 - $157.5	24
$157.5 - $200	32
$200 - $500	35
$500+	37

Source: US Tax Foundation, KPMG, Canada Revenue Agency.

The current 3.8% net investment income tax for higher-income taxpayers introduced under Obamacare is retained. Also unchanged is the taxation of net capital gains and qualifying dividends at a maximum rate of 20% or 15%, with the breakpoints indexed for inflation after 2018.

Other Tax Changes Affecting Individuals

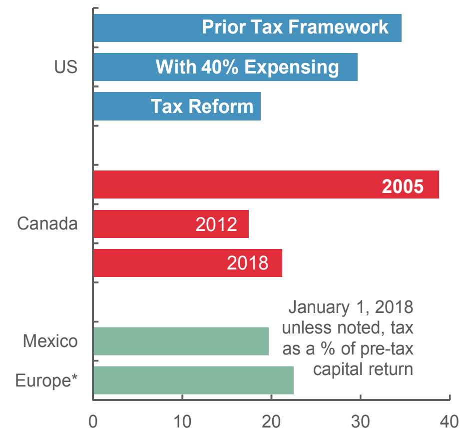
For the Estate Tax, levied at 40%, the existing $5.6 million exemption will be doubled as of 2018 and will continue to be indexed *(-$8 billion)*.

The excise tax on individuals not obtaining minimum health coverage, levied under the prior administration's *Affordable Care Act,* is reduced to zero as of 2019 *(+$6 billion)*.

[2] Except for taxes paid or accrued in carrying on a trade or a business.

<u>**Corporate Income Tax**</u> *(CIT)*

Chart 3 Marginal Effective Tax Rate on New Capital



* National tax rates weighted by GDP.
Source: University of Calgary, School of Public Policy.

A single-rate of 21% will replace the existing progressive CIT with a maximum 35% rate as of 2018 *(-$125 billion)*. Cash accounting will now be allowed for businesses with annual income up to $25 million, up from the current $5 million ceiling. Corporate net operating losses can no longer be carried back, but they can be carried forward indefinitely, though they are restricted to 80% of the firm's annual taxable income *(+$10 billion)*.

The corporate AMT is repealed. From 2018 to 2020, 50% of AMT credit carryovers exceeding a firm's regular tax liability will be refundable, and the remaining AMT credits will be fully refundable in 2021 *(-$7 billion)*.

Capital investment, specifically short-lived projects such as machinery & equipment, both new and used, can be 100% expensed for the next five years with a phase-out over the following five years *(-$36½ billion)*. This improves upon the bonus depreciation now in place through 2020. For small business, the expensing cap for investment is raised from $0.5 million to $1.0 million, and the phase-out would begin at $2.5 million, not $2.0 million *(-$7½ billion)*.

The deductibility of interest charges, however, will now be capped at 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) for the next four years and thereafter to 30% of earnings before interest and taxes (EBIT) *(+$18 billion)*. With respect to offshore interest expense, deductions are disallowed for transactions involving 1) related parties and 2) hybrid instruments or transactions.

Other business credits & deductions are adjusted, including capitalizing and amortizing Research & Experimental outlays and software development costs after 2021 *(in FY22, +$24 billion).* The deduction for income attributed to domestic production activity will be repealed *(+$9 billion)* and deductions for employee entertainment expenses and other fringe benefits will be curtailed.(+$4 billion). Though reducing industry-specific tax credits was an initial goal, the credits for wind & solar energy and affordable housing are retained.

For pass-through income received by an individual taxpayer, including a trust or estate, a 20% deduction is introduced on domestic qualified business income from a sole proprietorship, S corporations or partnerships, limited to the greater of: 1) 50% of the wages paid to the qualified trade or business or 2) the sum of 25% of wages plus 2.5% on all qualified, tangible depreciable property. An eligible business excludes professional services in fields such as law, health or accounting, unless the individual's taxable income is less than $157,500 *(-$47 billion)*. This represents a major saving relative to the existing practice of potentially taxing pass-through income at the top PIT rate.

<u>**International Business Taxation**</u>

The shift from the existing worldwide framework closer to a territorial system for taxing multinationals' global income involves complex and far-reaching adjustments, with Europe considering a WTO appeal on at least one of the changes. The conference agreement aims to scale back deferred taxation of foreign income within US-parented multinational groups and the proposed overhaul intends to tax foreign income as earned or permanently exempt portions of this income from US taxation. With respect to the latter provision, a domestic corporation that is a US shareholder in a 10% foreign corporation will receive a 100% "dividends received deduction (DRD)" for the foreign-source portion of the dividends received from the foreign corporation *(-$28 billion)*.

Reduced rates of taxation will be applied to a new broad class of income, "global intangible low-taxed income", *(+$12½ billion)* and to a new class of income earned directly by a US corporation, "foreign derived intangibles income" *(+$5 billion)*. To prevent the diversion of income to foreign jurisdictions with the new territorial framework, "base erosion provisions" include the Base Erosion Anti-abuse Tax (BEAT) at a standard 5.0% rate of modified taxable income over the regular tax liability through the first year, 10% through 2025 and 12.5% thereafter, with higher rates for banks.

In transitioning to a territorial system, deemed repatriation of tax-deferred foreign profits will be at a 15.5% rate for earnings held as cash or cash-equivalent assets and 8.0% for illiquid assets (+$79 billion in FY18; +$50 billion in FY19). The projected revenue in the first two years represents over one-third of the projected ten-year receipts, and is key in funding the early years of the personal and corporate tax reforms. At the former top CIT rate of 35%, this repatriation offers a $413 billion tax saving on the existing deferred taxes owing on offshore earnings.