Tax Reform Summary and Implications

The Tax Cut and Jobs Act of 2017 was passed by the U.S. Congress today and sent to President Donald Trump for his signature. This update provides a short summary of the bill along with our view on its major economic and financial market implications. This outlines our initial assessment regarding these implications, but PNC will be providing further analysis in the weeks to come.

This tax package is the second largest tax cut in U.S. history, second only to President Ronald Reagan's 1981 tax cut. The majority of the tax cuts begin in 2018, and the total amount of the cuts will be roughly 1% of 2018 calendar year GDP. The tax package provides both personal and corporate tax reform.

Individual Tax Summary

While seven tax brackets remain, five out of seven brackets will see a lower tax rate with the top rate falling to 37% (Table 1). The standard deduction is roughly doubled from previous levels and the alternative minimum tax (AMT) exemption amount is increased. Strategas Research Partners estimates that 95% of federal income tax filers will experience a tax cut. For example, a household with a median income of $75,000 with two children will experience a $2,000 tax cut on average. The new law provides for a 20% deduction to qualified pass-through businesses, with limitations and caps above $157,500 ($315,000 for married taxpayers filing jointly).

Table 1

2018 Income Brackets		2017 Income Brackets	
Tax Rates	Income Thresholds	Tax Rates	Income Thresholds
10%	$0 - 19,050	10%	$0 - 18,650
12%	19,051 - 77,400	15%	18,651 - 75,900
22%	77,401 - 165,000	25%	75,901 - 153,100
24%	165,001 - 315,000	28%	153,101 - 233,350
32%	315,001 - 400,000	33%	233,351 - 416,700
35%	400,001 - 600,000	35%	416,701 - 470,700
37%	> 600,000	39.6%	> 470,700

Cornerstone Macro, Joint Conference Agreement, PNC

The offsets for the rates for some taxpayers is the capping of the state and local tax exemption at $10,000. In addition, the mortgage interest deduction is lowered from $1 million to $750,000, and the deduction for home equity loans is repealed.

The estate tax exemption is doubled from $5.5 million to $11 million.

Corporate Tax Summary

The federal corporate tax rate declines to 21%. The corporate AMT was repealed. Previously, the U.S. had the highest corporate tax rate in the industrialized world. According to Strategas Research Partners, the estimated corporate tax rate including state taxes will be 25.75%. This is higher than the OECD average of 23% but lower than all G-7 countries except the United Kingdom.

As part of a transition to a territorial from a world tax system, a mandatory tax of 15.5% on cash and 8% on plant and equipment for unremitted foreign earnings was implemented. Previously the United States taxed foreign earnings twice, so many companies left those earnings overseas. Now companies will be able to return their foreign profits to the United States tax-free under the new territorial system.

Companies can expense 100% of their capital equipment purchases for five years. There will be limits on the amount of corporate interest expense that can now be deducted. Net interest costs are limited to 30% of earnings before interest, taxes, depreciation, and amortization through 2020 then 30% of earnings before interest and taxes thereafter.

Economic and Financial Market Implications

The size of the tax cut should provide upside to PNC's 2018 GDP growth estimates. Currently, PNC estimates 2018 GDP growth at 2.7%.

Our 2018 outlook already expected higher 10-year Treasury yields, but the tax package should raise the probability that this is correct. The 2003 tax cut was smaller than this one, but yields moved significantly higher following its passage and impact.

The size of the tax cuts accruing to individuals combined with good consumer balance sheets and a strong labor market could provide a significant boost to consumer spending, in our view.

Corporate earnings in the United States should see a significant boost as well. Our initial estimates of 2018 S&P 500® earnings growth was about 9%, but the significant decline in corporate tax rates likely lifts that estimate to around 15% growth. In general, companies with more domestic earnings benefit more from the lower statuary corporate tax rate. As a concrete example of the impact of the tax cut, FedEx Corp. (FDX) provided 2018 earnings guidance on December 19 both with and without implementation of tax reform. FDX estimates the midpoint of the company's 2018 earnings is 38% higher under the new tax law.

Corporate capital expenditures should be boosted by better economic growth, improved earnings, 100% expensing, and repatriation. All other things being equal, the Information Technology sector should be the beneficiary of significant capital spending.

Based on better earnings and repatriation, corporate share repurchases and dividends should increase. In addition, the effective tax on dividends falls from 50% to 40%. Dividends are taxed both at the corporate and individual level, so the sharp decline in the corporate rate has a large impact on the taxation level. More companies may also decide to pay a dividend based on the lower tax burden.

Mergers and acquisitions are likely to increase with the additional cash returning to the United States due to repatriation. This may open up more opportunities for event-driven alternative investment strategies. In addition, companies may decide to pay down some debt, especially with the new leverage limits noted earlier in order to retain the interest deduction.

Conclusion

The Tax Cut and Jobs Act of 2017 could have a significant impact on the economy. Interestingly, the eventual tax cuts were bigger at about 1% of 2018 GDP than either the Senate or House versions discussed previously. Both the consumer via the reduction in individual tax rates and corporations via higher earnings should benefit from some tailwinds. PNC will provide further analysis in the weeks to come.