Tax Reform

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AALU

Don't Let the Hype Around Tax Reform Delay Planning

As we explained in our last client communication in December, it is very challenging to do major tax reform, which is why it hasn't happened since 1986. Republicans began the year with an ambitious agenda that included completing both health care reform and tax reform by the August recess. Yet deadlines have slipped, and Republican leaders have a difficult push to complete tax reform by the end of the year.

Bottom Line: Republicans face significant challenges—particularly at the business tax rates currently being discussed by House Republicans and the Trump Administration. It is advisable that clients make decisions based on the existing tax code. If the tax picture changes, strategies can be adjusted accordingly. There are many hard realities associated with tax reform.

Tax Plan Details – It Will Be Difficult to Pass Tax Reform at the Ambitious Levels Currently Proposed

Both House Republicans and the Trump Administration have laid out ambitious goals for tax reform with deep across-the-board tax reductions for corporations, small businesses, and individuals, which would result in a significant loss of revenue for the government.

The Tax Policy Center estimated that Trump's overall campaign plan (which is very similar to his one-page proposal released last month) would reduce revenues by $6.2 trillion over 10 years, and the more conservative Tax Foundation estimated a revenue loss of $2.6 trillion to $3.9 trillion after accounting for greater economic growth. And this was without a 15% pass-through rate, which would likely add $2 trillion to long-term debt projections from these organizations.

Treasury Secretary Mnuchin says the tax cuts outlined by the Trump Administration will pay for themselves with economic growth. Yet it's widely disputed by economists on the left and the right. For example, Douglas Holtz-Eakin, a former Director of the Congressional Budget Office and economic advisor in the George W. Bush Administration, cautioned against the assumption that tax cuts will pay for themselves, suggesting that if interest on the national debt continues to steadily increase it could cancel out the benefits of reducing taxes.

That leaves Republicans with two options: find "pay fors" to replace the revenue loss from the proposed tax cuts, or resort to deficit financing. Both options present challenges.

Revenue Raisers

The fundamental truism of tax reform is that it is an exercise of picking 'winners' and 'losers'; recognized most famously by the late Senator Russell Long's (D-LA) aphorism of 'don't tax me, don't tax thee, tax the man behind the tree.' Politically, what makes tax reform perilous is that the 'winners' will generally stay quiet, while the 'losers' are vocal.

For example, one major revenue raiser for Republicans is the border adjustability provision in the House Blueprint, which would bring in $1 trillion to $1.2 trillion in revenue. Yet many net importers are very concerned about how that provision will increase their tax liability and impact the consumer. The Koch Brothers and Walmart are among those that have voiced their opposition.

Further, the House Ways and Means Committee is yet to produce any legislative text, and the 44-page House Republican Blueprint is silent on a number of key issues. Once tax reform is put into statutory language, there are likely to be hundreds of provisions that will engage and concern different industries and constituencies. Every single one of these industries and constituencies employ voters whose livelihoods could be impacted. The core challenge from a policy-maker perspective is trying to keep as many constituencies on board as long as possible.

Deficit Financing and Reconciliation

The other option is deficit financing. Some Republicans have recently softened their tone on deficit neutrality. Senate Finance Committee Chairman Orrin Hatch (R-UT) said he didn't know if a tax reform package needed to avoid adding to the deficit, and the White House has made clear that creating jobs and growing the economy would take priority over revenue-neutrality.

However, Republicans face an enormous obstacle to deficit-financed reform. While bipartisanship was always going to be difficult, Republicans have accepted that tax reform will be done on a partisan basis. Senate Republicans do not have a "supermajority" of 60 votes in the Senate, which means that passing tax reform requires a special Senate procedure called budget reconciliation, which comes with restrictions.

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The number of seats lost by Democrats after passing the largely partisan Affordable Care Act, Dodd-Frank Act, and cap and trade energy bill.

The major constraint is that reforms must be revenue neutral in the years following the budget window specified in the reconciliation instructions—typically 10 years. A common method of dealing with this challenge is to sunset a tax bill—i.e. after ten years all the tax changes would disappear, reverting back to the previous tax regime. This approach was followed with the Bush tax cuts in 2001. Yet the House Republican plan doesn't just cut rates, it significantly restructures major parts the Code. Sun-setting such legislation could prove to be exponentially more disruptive, potentially limiting options for tax reform.

In short, the reconciliation process provides a hard ceiling on the length of time that tax reform can run up the deficit.

Republicans Still Don't Have Agreement on Major Details

A key question surrounding tax reform is whether Trump and House Republicans can get on the same page, and produce a package broadly acceptable to the Senate. Even at this stage, it appears there are a number of unaddressed issues—and border adjustability isn't the only point of contention.

Unlike a number of tax ideas and plans that have been kicking around Washington for decades, the House Blueprint is a new framework that hasn't been fully vetted by Congressional committees and DC think tanks. The Tax Reform Act of 1986 took almost two years to pass after Ronald Reagan's Treasury Department issued a detailed tax report in 1984, and there were several tax plans with well-known concepts floating around Congress. Given the complexity of border adjustability or other potential provisions to shift to a more territorial system, and the fundamental change it would bring to the Code, it will be challenging to develop legislative text that addresses all potential concerns.

"It is just completely unrealistic to think [Republicans] can get a big tax reform bill done this year. They haven't even agreed whether they are doing tax cuts or tax reform. They haven't decided if it needs to be paid for or not and I don't think they appreciate just how big a fight the debt limit is going to be." - Greg Valliere, Chief Global Strategist at Horizon Investments

Presidential Popularity - Reagan was at the height of his popularity as tax reform was being debated and legislation was being marked up – with approval ratings above 70% for most of 1985 and a 64% approval ratings 3 weeks before the Tax Reform Act was signed into law.

Congressional Calendar/Senate Environment

The Congressional calendar will continue to hamper Republicans in their quest for a quick passage of tax reform.

Health care reform is the biggest immediate hurdle, as it creates a procedural bind for Republicans. With no Democratic support forthcoming, they must use reconciliation. The widely held view in Washington is that Congress can't pass a FY 18 budget resolution with reconciliation instructions for tax reform until the FY 17 budget resolution with the health care bill has passed both the House and the Senate. In fact, the Senate Parliamentarian hasn't ever ruled on this question, which means it's possible that Congress could pass the FY 18 resolution with reconciliation instructions for tax reform before finishing health care reform. Yet it's a gigantic "if"—should the Senate Parliamentarian rule that the passage of the FY 18 budget resolution does invalidate the FY 17 budget resolution, then the health care bill will fail. So starting the FY 18 process before concluding health care reform is a very big risk for Republican leaders. While the House passed their health care reform bill May 4th, it's not popular in the Senate, and has challenges with the public. It is likely to take months for Republican Senators to modify the House bill, at a minimum. In short, health care is likely to push back tax reform back even further.

In addition to tacking health care and tax reform, Congress will need to raise the debt ceiling sometime this Fall, reauthorize funding for SCHIP and the FAA, and confirm a number of key unfilled cabinet positions.

These efforts will take place in a tense Senate environment, where the firing of FBI Director James Comey further strains party relations already roiled by the use of the nuclear option in the nomination of Neil Gorsuch to the Supreme Court.

AALU Bottom-Line Analysis: An era of political uncertainty should make life insurance products more attractive – not less – to clients given their consistent performance as well as their current and long-standing tax treatment. The challenges outlined above are a mere fraction of the challenges that tax reform will present to policymakers. As such, it would be advisable for clients to recognize these challenges, make decisions based on current law (and refrain from speculation), and adjust their strategy if necessary when, and if, new tax laws become clear.