Tax Reform: Challenges Ahead
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With great fanfare, the White House and Republican congressional leadership released their long-awaited framework for tax reform, but many politically thorny issues need to be resolved – and quickly – before investors can feel confident that tax reform will materialize in the coming months.

On the individual side, the plan proposes to collapse tax brackets from seven to three (12%, 25% and 35%), double the standard deduction to $24,000 (although the personal exemption would also be eliminated, making the increase in the standard deduction less generous) and abolish the alternative minimum tax and the estate tax.

The proposal also reduces the statutory corporate tax rate to 20% from 35%, allowing full expensing of capital investment for five years, and reducing the pass-through rate to 25% (instead of an individual’s rate).

While the proposal provides a broad outline for a possible tax bill, it is important to remember that the real heavy lifting lies ahead, especially given that many critical questions remain unanswered. For instance, the proposal indicates that the majority of individual deductions – with the exception of the mortgage interest and charitable deductions – should be eliminated. This would help to pay for the individual tax cuts, but leaves the politically perilous job of figuring out which deductions to eliminate to the tax-writing committees.

The challenge is that each deduction is considered sacrosanct by different constituencies, who are oftentimes sympathetic to policymakers – not to mention well-mobilized and well-resourced.

Case in point: Associations of governors and mayors have already begun lobbying to preserve state and local tax deductions, targeting Republican members from states such as New York and California (where income taxes are high), as well as Texas (where property taxes are high). If they succeed in preserving these deductions, tax writers will have significantly less revenue – about $370 billion over five years, according to the Joint Committee on Taxation – to use to cut rates. Thus, any tax bill would either be smaller or add significantly to the deficit, either of which may be politically untenable.

Not only is the act of translating a feel-good proposal to the realities of legislative text an uphill exercise, but Republicans must also pass a fiscal year 2018 budget before they can tackle tax reform in earnest – something they have not been able to do all year. Why? Republicans plan to use the budget
reconciliation process, which allows bills to pass with 50 votes in the Senate – not the usual 60.

To do so, however, they must first pass a unified budget that includes reconciliation instructions on tax. To date, there has been no agreement about the size of tax cuts and how much they should add to the deficit (if at all).

The bottom line: While the proposal is a step forward from the one-pager on tax reform we saw earlier this year, many substantive and politically treacherous issues need to be resolved before investors should feel confident of action on tax before the end of the year, let alone before the midterms.

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