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WEEKLY ECONOMIC COMMENTARY

IN THIS ISSUE:

- Is The Timing Right For Tax Reform?
- Different Companies, Different Taxes
- Saudi Arabia's Next Steps

Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

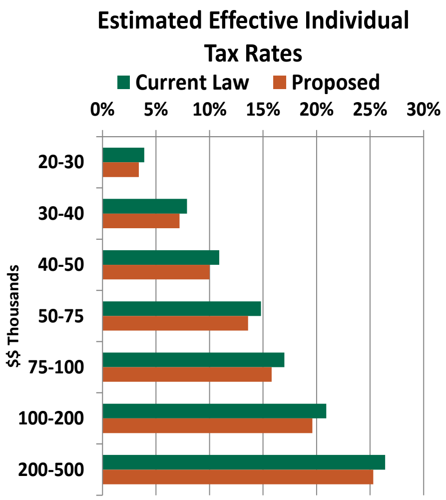
Ryan James Boyle
Senior Economist
312-444-3843
rjb13@ntrs.com

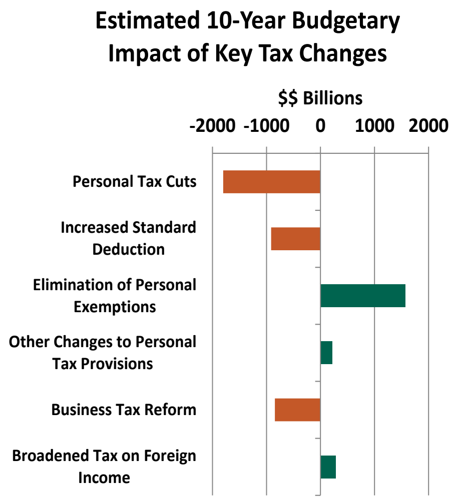
We've faced a difficult adjustment since dropping our youngest off at college three months ago. The kitchen is devoid of random dirty dishes and there is no arguing over bathroom sanitation, but we miss the chaos. It will be nice to have everyone home for Thanksgiving.

Not only are our children moving away, but it appears the tax credits we get for them may also be on the way out. The elimination of personal exemptions is one of many features of the tax reform proposal presently being debated in Washington. If passed, the new regime would realign the finances of industries, households and even countries.

Success is by no means assured. The U.S. House and Senate are working on different versions that will have to be reconciled. Lobbyists are actively working to preserve preferences now on the chopping block. The net impact of the changes may add too much to the national debt. But despite the challenges, the odds of a real tax reform have risen.

Two factors have added momentum to the reform effort. Firstly, Congress has given itself additional room to run fiscal shortfalls over the coming decade. Deficit "hawks" ultimately dropped their opposition, lured by the prospect of fixing what they see as weaknesses in the current system. Secondly, after failing to repeal or replace the Affordable Care Act, Republicans are seeking a legislative achievement that will play well during next year's midterm election cycle.





Source: Joint Committee on Taxation

The outline released by the House late last month re-writes both the personal and corporate tax rules for U.S. taxpayers. In an article this summer, we suggested corporate tax reform should be considered separately, and as a higher priority: the U.S. is at a competitive disadvantage with low-tax countries, and taxing the profits earned by offshore subsidiaries of U.S. companies could limit the loss of revenue.

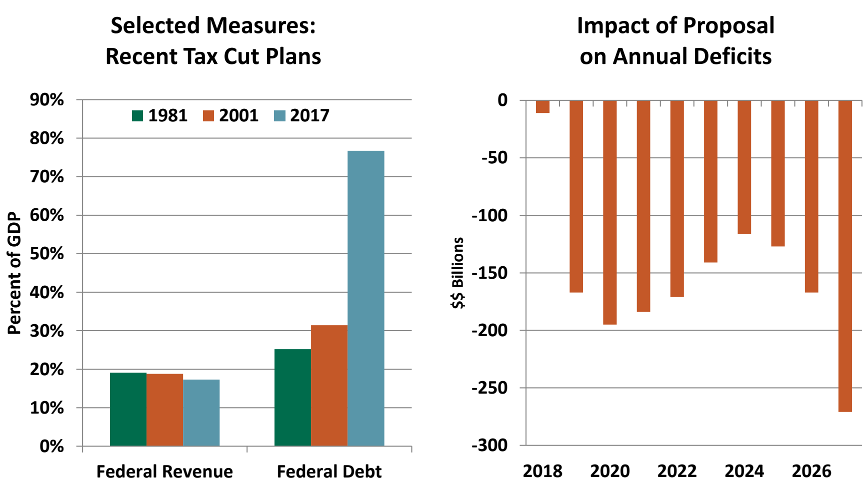
The House proposal lowers the large corporate tax rate to 20%, but "broadens the base" by removing deductions and credits. It also moves the U.S. towards the territorial system used in most other countries. Profits of U.S. companies that are currently held overseas would be taxed whether they are repatriated or not. This would reduce the motivation for U.S. companies to "invert," or to shift activity outside of the country. Other aspects of the outline are hostile to imports.

The authors of tax reform are attempting to offset lower rates with a broader base.

But three-quarters of American companies are "pass-through" entities, meaning that profits are assessed at the personal tax rates of their owners. Providing relief to big companies without doing the same for smaller firms would have been seen as unequitable. And so the current House outline contains a special rate for many small firms that would be lower than the one they pay currently (see following article).

For individuals, a central change would be a doubling of the standard deduction. This, along with the curtailment of specific deductions like those for mortgage interest, property taxes, and state taxes, would result in significant simplification of personal returns. Of course, families that have relied on those preferences, along with industry groups that would feel aggrieved at their departure, are pressing to retain them.

With details now a little clearer, the proposals will be subjected to the scoring process that we described in our piece "Fuzzy Math on Fiscal Policy." On a "static" basis, the outcome cannot add more than $1.5 trillion to the national debt over the next decade, an amount that represents 8% of today's gross domestic product. Staying within this allotment is not proving to be very easy.



Sources: CBO, Joint Committee on Taxation

Reform proponents will note that lower tax rates are expected to release additional economic activity, and the tax revenue derived from that increment can help limit the expansion of deficits. This is the realm of dynamic scoring, which will be carried out by the Joint Committee on Taxation (JCT). An essential assumption in this process will be what happens to interest rates as deficits rise; early estimates suggest that long-term yields could rise by at least 50 basis points. Pushing further on growth could finally trigger higher levels of inflation, which could prompt the Federal

Reserve to tighten monetary policy faster than currently anticipated.

The negative impact of higher interest rates on economic activity could be enough to offset the benefit of lower tax rates. Several private forecasters have concluded that the House plan would add very little to economic growth over the coming decade. The "official" figures from the JCT should be available next week.

So from an economic perspective, it is not clear this is the best time for sweeping tax reductions. By many measures, the U.S. economy is operating close to full capacity. Government revenue is lower and debt is substantially higher than it was the last two times taxes were reduced. The artifice of using a ten-year window to determine the effect of a proposal ignores what happens beyond that point: America's long-term budget outlook remains challenging, and the current outline does little to change this narrative.

Some ideas in the proposal are very good, but the timing may be poor.

Determining the impact on one's specific finances is difficult at this point, as is sorting out winners from losers among industries and states. Northern Trust's tax director, Suzanne Shier, has been following events from close range, and her initial analysis of the proposal can be found here. She will certainly be filing updates as events unfold.

There are some intriguing elements to the tax reform outline that deserve our consideration. But we cannot look at them in isolation, or over a limited period of time. The fiscal decisions we make today are ones our children will have to live with. I would hate for their inheritance to be a mountain of debt that limits their prospects for prosperity.

Pass Interference

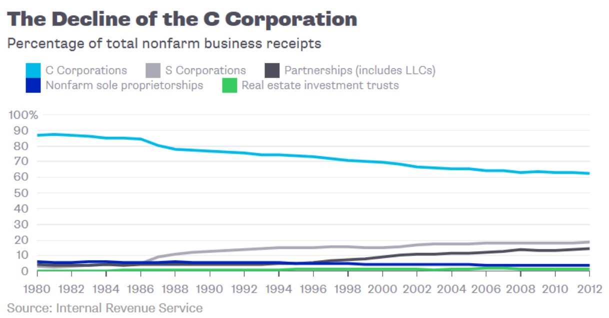
Among the many aspects of the House proposal is a new treatment of income derived from ownership in pass-through companies. While many of the headlines have focused on the potential effects of tax reform on large companies, this commentary will focus on the implications for smaller organizations.

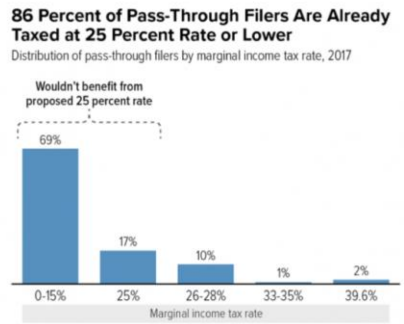
Pass-through companies are entities that pass their net income or losses through to their owners. These include sole proprietorships, limited liability companies (LLCs) and subchapter S corporations. These business structures are generally simpler to create and manage, and their tax treatment is often favorable. The business entity does not pay income tax on its own behalf; all net income and losses are passed to the business owners, who count it as personal income.

S corporations stand in contrast to more conventional C corporations, the structure under which the company files a tax return and pays corporate taxes on any profits. Any after-tax income paid as dividends to its owners is then recognized as income on the owner's tax return. The corporation's income is effectively taxed twice: first by the corporation, and then by the shareholder.

Many small business owners find value in the tax treatment of S corporations, leading to a gradual decline in the number of C corporations. A high-income S corporation does run the risk of putting its owner into the highest tax bracket; the top marginal personal rate of 39.6% is higher than the current 35% corporate tax rate. However, under the current regulations, this would only be a consideration for the small share of taxpayers with incomes over $418,400. The clear majority of pass-through business owners pay much lower tax rates, as they do not meet the high income thresholds that incur the highest marginal rates.

The Republicans' tax proposal includes a change that would benefit many owners of S corporations, partnerships and sole proprietorships. Instead of potentially pushing that taxpayer into a more expensive tax bracket, the proposal would tax all passive income from these businesses at a flat rate of 25% on that individual's tax return.





Sources: Bloomberg; Center on Budget and Policy Priorities

Tax policy is rarely simple, and this reform requires caveats. Along with the change to the treatment of business income, the reform proposal includes a change to individual income tax brackets. The decrease in the pass-through tax rate would only be relevant to taxpayers who would pay a marginal rate of greater than 25%. In the proposed reform, this would translate to household income over $260,000 for married couples filing jointly.

This reform would create incentives for high earners to restructure themselves as "businesses" for tax purposes. Given the choice between paying a 39.6% top rate or a 25% business rate, enterprising taxpayers may try to qualify for the lower rate. Policies and enforcement would be needed to limit any gaming of the tax code. In an apparent attempt to reduce the likelihood of individuals abusing the pass-through rate, the reform carves out certain industries. Professional-services businesses, such as law firms, consultancies and accounting companies, are excluded from the new S corporation rate. Owners of these firms would continue to pay labor income taxes.

Business owners may need to reevaluate their tax strategies if reform passes.

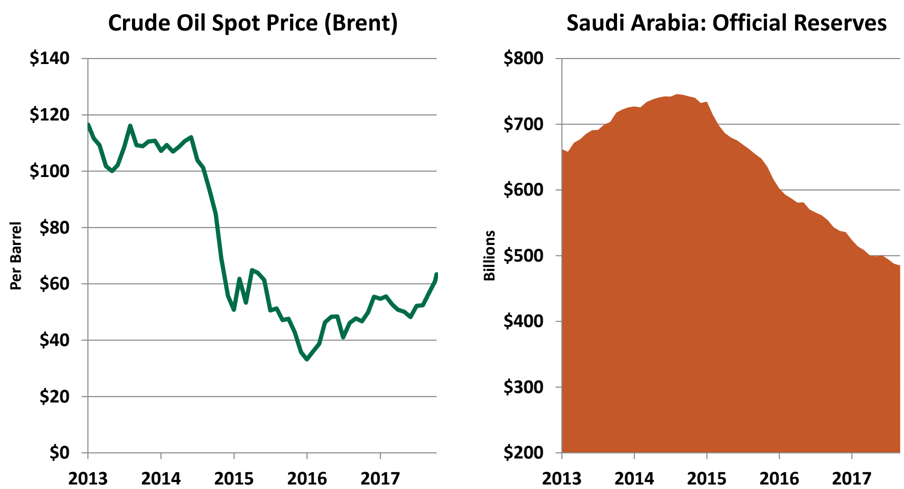
What changes in behavior can we expect in light of these reforms? In the big picture, we do not see this causing any gain or reduction in business formation, mergers, acquisitions, divestitures or failures. Income taxes are only paid on profits; viewed in that light, they are a good problem for a business owner to have. High-earning C corporation owners may see a tax benefit to converting to a pass-through structure, continuing the long-term trend away from the choice of organizing as a C corporation. The only certain near-term winners are the corporate advisors and tax experts who will determine the best way forward for their clients.

A Man in a Hurry

A month ago, I offered reflections after a trip to the Middle East. While in Saudi Arabia, I stayed at the Ritz Carlton Hotel in Riyadh; the word "palatial" doesn't do it justice. I didn't feel guilty; the bank recommended I stay there, and I had stayed in a modest Club Quarters hotel on my prior trip.

Last weekend, the Ritz Carlton Riyadh became a detention center. On orders of Crown Prince Mohammed bin Salman, 11 princes and scores of former ministers were arrested on corruption charges and confined to the hotel. The "purge," as some are calling it, was the latest step in the Prince's headlong drive to modernize the kingdom.

The accusations suggest that $800 billion in assets have been misappropriated by the group, an amount well in excess of Saudi Arabia's official reserves. Saudi ministries have a reputation of being fiefdoms that allow their leaders to amass wealth, but, until now, no one within the Saudi government has sought to make an issue of this practice. Some suspect the threat of prosecution is an attempt to keep capital from leaving the country, or to coerce wealthy Saudis to finance some of the prince's more ambitious projects, including a huge new city in the north of the country. Other regimes around the world have used anti-corruption campaigns selectively to reduce political opposition.



Source: Bloomberg

Aggressive measures for challenging times.

We are certainly not in a position to judge the legitimacy of the charges or comment on due process. But recent steps can certainly be viewed as a sign of the urgency with which bin Salman is approaching the task of restructuring the Saudi economy. Even though the price of oil has sprinted upward in the wake of the upheaval, few think the price of crude will return to levels that will support the Kingdom's former way of life. Opposition to change, which would delay progress, is not being tolerated.

To outsiders, the ends may not justify the means, but we all have a stake in the outcome. Failure would mean even more tumult in the Middle East, which could be upsetting to investors. As the Sons of the Desert went, so may go the financial markets.

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@NT_CTannenbaum