CARLSON FINANCIAL MANAGEMENT

TAXATION with REPRESENTATION

Congress has responded to the public's demand for tax reform by passing the Tax Cuts and Jobs Act. It is family friendly, business and entrepreneur friendly while at the same time being a bit hostile towards blue states, those that vote Democratic. In sum, it reflects the prejudices of the people who elected the majority of our representatives.

The Act does indeed cut taxes for nearly all taxpayers. The bill will increase the share of American households that pay no federal income tax from 44% to 47.5%. The Tax Policy Center, hardly a conservative organization, estimates that the bill will raise after tax income by about 2%. The benefit won't be spread evenly; the lowest fifth (by income) of taxpayers will see their annual receipts rise by .5%, a fraction which rises steadily until the top 95-99%, who will see income gains of 4%. This isn't quite as unfair as it may seem. The bottom portions of the income pyramid don't pay much federal income tax to begin with. The top 10% of taxpayers pay about 75% of the total while the top 1%, the infamous one percenters, pay one-third.

Still, there are significant savings at all steps of the economic hierarchy. In 2017 a married couple with two children and no itemized deductions pays no tax until the family income is over $48,000. For 2018 that amount rises to just over $60,000. This is due entirely to an increase in the child credit to $2,000 from $1,000 per child.

A single person with an income of $30,000 and no dependents or itemized deductions should see his federal income tax fall by 20%. The congressional joint tax committee estimates that the reduction for all taxpayers will be $189 billion in 2019.

The few people who will see an actual tax rise are those who are in the unfortunate position of being residents of high tax states, like California. State and local taxes are no longer fully deductible. Now the deduction is limited to $10,000. A couple with $225,000 income, $12,000 in real estate tax, $15,000 in mortgage interest and $13,000 of state income tax will pay about $600 more than they would under the old law. The problem is compounded if this couple is hoping to buy a home. The home mortgage deduction is now limited to the interest on the first $750,000 borrowed, down from $1,000,000. In the Bay Area a starter home costs $1,000,000 plus.

If the couple above has just purchased a million dollar home their tax will be $1,500 more than under the old law.

The additional revenue to the government as a result of restrictions on home mortgage interest and state and local tax is estimated to be $593 billion over the next ten years. That is almost exactly the amount, $590 billion, that the increased child credit will cost.

While the law's benefits are tilted toward red states the big beneficiaries are a more narrowly defined group. The Tax Cuts and Jobs Act should more properly be entitled the Investors and Self-Employed Act. The self-employed will enjoy an enormous new deduction. Owners of unincorporated business, be it a sole proprietorship, partnership, LLC or Sub S can deduct 20% of their business income from their otherwise taxable income. Two couples living with the same income in the same neighborhood could pay very different tax bills as a result of their differing employment status. If one has wage income of $300,000 and no children or itemized deductions, that couple will pay a bit over $55,000 in federal income tax. If the income was from self-employment the tax would be $15,000 less.

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The Act's proponents argue that this additional amount is needed for business expansion. They are certainly representing the interests of the small business community who have been telling them that less tax means more investment and more investment means more jobs. Joined to this is the assurance that the demand for increased goods and services is there but proprietors are just not in a position to satisfy it. It is hard to know how true this is but certainly throughout the recovery from the Great Recession there have been complaints that increased bank regulation has meant that small business is starved for capital. If we see a dramatic rise in small business activity the Act's supporters will be proven right.

This section of the law is very complex, including lots of qualifications and uncertainties. But anyone who has their own business should run not walk to their tax advisor to see what the impact will be.

The same rationale, greater investment hence more jobs, is made to support the cut in corporate tax. The rate was 35% and is now 21%. Estimates are that this will save corporate America over $1.3 trillion dollars during the next ten years. That is roughly $130 billion per year. Here, though, it is difficult to make the argument that big corporations are suffering from lack of capital. There is money all over the place. The Federal Reserve has around $2 trillion of deposits from banks that can't find enough credit worthy projects to justify a loan. The companies themselves have over $2.6 trillion in cash on hand. An argument made by the Act's supporters is that corporations are hindered in access to that capital because a large part of it is parked overseas, hence it is not available for domestic investment. This is so because most other countries' corporate tax rates were, until now, much lower than American rates. If the money were repatriated then corporations have to pay the difference between the foreign tax and the American tax. Now that problem is solved. All profit held overseas is, in tax code lingo, 'deemed' repatriated. In other words it is going to be treated as if it were brought back no matter what the corporation does. But it will return being taxed at a very preferential rate.

Corporate capital investment has been falling. For the twelve month period ending June, 2016 investment was $608 billion, down 8.7% from the prior year. In the following quarter, the latest for which we have figures, the annual rate had fallen again. Although there is a lot of money outside of the country there is still plenty held domestically to fund more capital expense, if the potential business was there.

So what will corporations do with this vast new wealth? They will do the same things that they have been doing with most of their profit for the last many years. They will buy back stock and pay dividends.

In the twelve months ended June 2017 the S&P 500 corporations, America's biggest companies and those that make up about 80% of the stock market, bought back $501 billion of stock and paid $407 billion in dividends. We can measure these numbers against a few trillion dollars newly available from offshore profit plus maybe $130 billion each year in additional gains. A few hundred billion more in buy backs will go a long way toward pushing up the market. A few hundred billion more in dividends will make stock market investment look good when banks are paying interest of .1%. Investors should do well by the Tax Cuts and Jobs Act.

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