Tax Reform Update

December 20, 2017

THE ECONOMY

The U.S. deficit will rise substantially as a result of tax reform, by about $1.46 trillion over the next 10 years, according to the nonpartisan Joint Committee on Taxation.

We believe that tax reform will add stimulus to an already accelerating U.S. economy, at least in the short run. Longer-term economic benefits are uncertain, as many of the provisions sunset within seven years. Larger deficits will put pressure on government spending and economic inequality will be exacerbated – all of which will contribute to continued political discord.

We differ from many investors in that we believe that corporate tax cuts will be disinflationary, not inflationary. Lost in the debate about whether the windfall from the tax cuts will go to business owners through more share buybacks and dividends and maybe some additional capital investment, or go to labor through higher wages, is the third, rather likely, possibility that the benefits will go to customers. In a competitive business when there is a sudden drop in costs – in this case, taxes – there is a strong tendency to cut prices or, at the very least, not increase them as much as planned.

THE INVESTMENT MARKETS

Equities: The upside of the cut in corporate tax to 21% may have been largely priced into the markets – investor anticipation of a substantial cut was a large driver of the 22.1% gain in the S&P this year through December 18, 2017. There will be a one-time 14.5% tax on all foreign earnings, but this change should encourage companies to repatriate cash. While these funds will hopefully spur domestic investment, they will also likely go to increased buybacks and to M&A activity. The real long-term implications for those companies with substantial overseas operations and earnings remain unclear.

The other key component is that the foreign earnings of U.S. companies will no longer be taxed in the United States. This should be modestly positive for truly global companies, as the new 21% rate is in line with most foreign tax rates (the OECD average is 25%). It eases tax considerations when making capital decisions and should increase flexibility in making capital spending and investment decisions.

Evercore portfolios have significant exposure to the information technology and consumer discretionary sectors. Both of these sectors should be positively impacted. The information technology sector has some of the highest amounts of overseas cash and earnings. Although these companies may take a one-time hit to pay the repatriation tax, their prospective foreign earnings will be free to come back to the United States and their local taxes will now be on average similar to the new U.S. rate. The consumer discretionary sector tends to be very U.S.-centric and currently has some of the highest effective tax rates, so the reduction in rates should flow directly through to earnings.

Municipal bonds: While the bill had the potential to severely restructure the municipal bond market, the final legislation has left the market pretty much intact. The three most likely significant impacts are:

1. The loss of advanced refundings as tax-exempt debt. Supply will be reduced (about 15% of total issuance) and will make it more difficult for entities to achieve debt service savings.
2. Lower demand from banks and insurance companies, as corporate tax reduction makes the yield on corporate securities more attractive. They currently account for 23% of the total $3.8 trillion municipal bond market.
3. Increased interest among investors in high-tax states in tax-exempt municipal bonds. The $10,000 cap on state and local tax deductions could also hamper the ability of high-tax states and localities to raise taxes.

Alternative assets: Investors in private equity and private real estate investments will generally benefit from the lower corporate tax rates and deductions for pass-through income. Changes to the timing of carried interest will not materially affect most private equity and real estate funds (or the managers of those funds).

One aspect of the new tax code that could have a slightly negative effect on some alternative assets is the limit on the deductibility of interest costs. The new law will limit the amount of interest that can be deducted to 30% of earnings before interest, taxes, depreciation and amortization through 2021 and 30% of earnings before interest and taxes thereafter. This will make high amounts of leverage less tax-efficient for companies, and may make some of the highly leveraged private equity transactions less appealing. Golub Capital Partners, one of our long-term external managers, invests in corporate loans issued by companies that have been taken private. While highly leveraged companies will be disadvantaged by the new law, the companies that Golub lends to typically have a reasonable debt load, and most are not expected to be materially impacted by the new law.

WEALTH PLANNING

The new tax law retains the seven individual tax brackets and doubles the standard deduction; the top tax rate is now 37%. (Please see below.) For individuals and couples who no longer itemize, these changes will reduce the attractiveness of smaller charitable deductions and some other forms of giving from a purely tax perspective. They are unlikely to impact those who have broader reasons to transfer wealth.

It should also be noted that most provisions sunset after year 2025.

Rate	Individuals	Married Filing Jointly
10%	Up to $9,525	Up to $19,050
12%	$9,526 to $38,700	$19,051 to $77,400
22%	38,701 to $82,500	$77,401 to $165,000
24%	$82,501 to $157,500	$165,001 to $315,000
32%	$157,501 to $200,000	$315,001 to $400,000
35%	$200,001 to $500,000	$400,001 to $600,000
37%	over $500,000	over $600,000

Income tax:

- The top tax rate is now 37%, down from 39.6%, and most tax bracket breakpoints have been modified to benefit the taxpayer. The alternative minimum tax, or AMT, phase-out threshold has been raised to $1,000,000 for married couples ($500,000 for all others) from $500,000, and the AMT exemption has increased to $70,300 for single taxpayers and $109,400 for married taxpayers. As indicated in the attached chart, this should result in fewer taxpayers being subject to the AMT.
- The standard deduction has been doubled to $12,000 for single taxpayers and 24,000 for married couples.
- The $10,000 cap on state and local taxes, or SALT, and property tax deductions will affect families in high-tax areas, including New York, New Jersey, Connecticut, California and Minnesota.
- Other deductions:
  - The 3% overall limitation on deductions, which reduced deductions by 3% of adjusted gross income, or AGI, over a certain dollar threshold (the Pease Act), is suspended through 2025. The should be a positive for the taxpayer.
  - The mortgage interest deduction is limited to total mortgage amount of $750,000 for acquisition after December 15, 2017 through 2025 for both primary and secondary homes. The home equity interest deduction is repealed.
  - The ability to take a miscellaneous itemized deduction subject to a 2% floor (these expenses in aggregate are not deductible unless they exceed 2% of AGI), such as tax preparation and investment management fees, has been suspended through 2025. This should be a negative for the taxpayer.

Estate and gift tax:

- The basic exclusion amount for estate and gift tax purposes has been doubled to $10 million from $5 million, adjusted for inflation from 2011. The 2018 exemption per individual will be $11.2 million, as adjusted for inflation. The Federal estate and gift tax rate is maintained at 40%.
- The step-up in basis at death is maintained.
- The top income bracket for estates and trusts is now 37%, down from 39.6%.

Charitable giving:

- There are no significant changes in charitable giving, other than the increase in the AGI limit for cash gifts only (60% vs. 50%).

Other notable changes:

- 529 plans will allow a distribution of $10,000 per beneficiary annually to be used for primary and secondary education.
- For all agreements after December 31, 2018, alimony will no longer be deductible by the payor or includible as income by the payee.

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