Tax Reform

# Despite All the Vegetables, Some Very Sweet Treats

***The Takeaway:***

> *We view yesterday as incrementally positive for tax reform's prospects and therefore reposition our 75% odds as now trending up that both chambers of Congress can pass a measure by the end of 1Q2018. We were encouraged by the following developments in areas we've been watching: 1) reaction by House Ways and Means Republicans that was mostly positive, with only a few silent and no negative responses; 2) resoundingly positive endorsements by pro-business groups the U.S. Chamber of Commerce and Business Roundtable; and 3) even some indication that conservative House Democrats may be in play during future negotiations. We were further encouraged by the Joint Committee on Taxation score released late yesterday afternoon, which revealed that House tax writers have pieced together a final draft that costs $1.487 trillion, less than the maximum $1.5 trillion, and does not rely on revenues from individual-side reforms to pay for corporate cuts, satisfying many of the procedural and political revenue requirements we'd previously identified as necessary for passage. Therefore, we think there is plenty of room for horse trading over the weeks and months to come that again reinforce our 75% odds for eventual passage. Today's report covers the broader political environment for tax reform, identifies where some of that horse trading will likely take place, and dives deeper into several provisions with sector-specific implications across financial services, housing, healthcare, technology, and energy & industrials.*



**Height Securities, LLC** | 1775 Pennsylvania Avenue NW Washington, DC 20006 | www.heightllc.com | (202) 629-0000

*Note: we dive right into our analysis and assume that most readers are generally familiar with what is in the House draft at this point. As a reference, however, please see the final section of this report for a summary of what was included in the House tax reform draft.*

### *Status update on indicators we've been watching for encouraging signs*

In our October 31 report, we discussed how under any scenario we expected the press around tax reform to turn increasingly negative after policymakers finally unveiled the proposal's details, no matter what an ultimate tax draft looked like. But we cautioned that amid all the noise there were three things we were and are watching in the hours and days following the rollout of the House draft. All three of these indicators are trending positively:

1) **Lack of negativity from House Ways and Means Republicans**. So far, by our analysis and monitoring, we have seen absolutely no negative reaction by any Ways and Means Republicans – nearly all spent the day yesterday promoting the tax reform proposal and those that didn't were not in the press saying anything negative.

2) **Moderate-to-positive endorsements from the U.S. Chamber of Commerce and Business Roundtable**. Both organizations issued resoundingly positive endorsements of the House draft (see HERE and HERE).

3) **Any signs of bipartisanship (or room for bipartisanship) among moderate members of the House Democratic caucus**. Within just a few hours of the release of the House draft, conservative Members of the Democratic Blue Dog caucus announced that they were reviewing the legislation, indicating a willingness to potentially negotiate in the future.

### *General takeaways and big sticking points ahead*

In general, nothing that's occurred over the past 24 hours has caused us to back off our projections. But now we have additional details that we discuss throughout this report. Before we do so, however, in general we continue to place 75% odds on Congress passing a tax reform measure by no later than the end of 1Q2018 that cuts the corporate rate to at least 25%, shifts to a territorial tax regime for multinational income with deemed repatriation of prior earnings stockpiled overseas, creates a new preferential rate of roughly 25% on certain pass-through business income, simplifies the individual tax code / modestly consolidates the existing seven tax brackets down to four or five, and provides middle class tax relief.

As we wrote in our October 23 report, the final elements of a tax reform bill are driven just as much by the budgetary considerations / reconciliation rules as the larger politics of various tax provisions. The Joint Committee on Taxation (JCT) late yesterday released its score of the House's draft bill. Some important points to note as it relates to our viewpoint:

- **In general, this looks tough but doable**. Overall, the JCT estimates the House draft would cost $1.487 trillion, which is less than the $1.5 trillion required by the budget reconciliation instructions. Changes on the individual side would cost a total of $929.2 billion. The rest of the changes to business tax treatment would cost a total of $557.9 billion. The optics of that look far better politically than having corporate-side changes cost more than individual-side changes (again, full details in our October 23 report). And the fact the House has some – not a lot, but some – money to play with going forward will be helpful when trying to find resolution to sticky issues (more on those below). The biggest issue remaining is that we don't know what happens to the budget in the out-years. In order to move on reconciliation, the deficit impacts need to go down to zero in year 11 or the entire bill will have to be temporary – not an option politically. This means that additional revenue raisers will likely need to be considered going forward…

- **We expect continued pressure for the corporate rate to end up closer to 25% than 20%, and there will be continued pressure to include additional measures to raise revenue**. Per the above, we think some changes will need to be made to bring the bill toward an out-year revenue number that's compliant with reconciliation instructions. Both the individual and business titles of the bill lose revenue. The amount of revenue they lose over the second five years is less than the amount of revenue they lose over the first five years, so they are at least trending in the right direction. But to make these provisions permanent, lawmakers will need to find more revenue. We think this will bring about changes on the corporate rate (moving it up to 25% we estimate would save $500 billion) and but additional provisions absent from yesterday's bill back on the table, such as repeal of the advertising expense deduction (which would save $169 billion over ten years).

**The bill unveiled yesterday represents an opening salvo for both Republican negotiators and Democratic opposition**. Negative headlines (see here, here, here) swirled around the fact that Republican lawmakers proposed sweeping cuts to beloved individual-side tax preferences. For example, GOP lawmakers proposed to cap the home mortgage interest deduction for mortgage indebtedness in excess of $500,000. They also proposed to make student loan interest no longer deductible and repeal the credit for adoption expenses. It is extremely likely Democrats are going to take these provisions and spin them, saying that tax cuts for the wealthy—an eventual phasing out of the estate tax—and a reduction in the corporate rate are being paid for by individuals. This line of criticism is unfounded. In our view, Republicans did a (surprisingly) good job of ensuring individual side cuts are in one bucket and business provisions are in another bucket. Still, in Washington, lawmakers opposed to the bill will likely look past this logic to argue the unfairness of the bill. Lawmakers are going to need to assuage voters who will be upset that favored tax benefits could be stripped away and at the same time try to win over real estate business groups that could get in the way of this bill. Thus, it is likely that policymakers could make some modifications to the above-named provisions.

**Pass-throughs**. The House draft proposed a new lower 25% rate for pass-through businesses with certain exceptions, reinforcing our prior projections around pass-throughs. Professional service firms would be *excluded* from this lower rate. Other business owners can choose to categorize 70% of their income as wages, subject to ordinary income rates, and 30% as business income, taxable at the 25% rate. In a statement from September, the S-Corp Association, a trade group that represents a sub set of pass-through businesses, said it opposed the 70/30 rule three years ago when it was proposed and continues to oppose it. The S-Corp Association asserts that the 70/30 rule could lead to a tax increase on business owners in certain cases.

**Interest deductibility**. The interest deductibility provision took a so-called thin capitalization approach, which we have been projecting is what a final provision here would look like. We were surprised to see the cap hit a 30% of EBITDA rate, as we had been preparing ourselves for a slightly lower cap to raise more revenue. Instead, that revenue came from the fact that the provision does not provide a grandfathering or safe harbor provision for interest on existing debt. Under the proposal, every business, regardless of its form, would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. Adjusted taxable income is a business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion. There is an exception for small businesses with average gross incomes of $25 million or less. The carve-out for small business helps eliminate a key potential point of resistance. Small business groups had argued since 2016, when the House GOP Tax Blueprint was released, that not providing an exception for small businesses that cannot access the capital markets would be punitive. We think going forward there will likely be pressure on lawmakers to consider some sort of softening of the treatment of interest payments on existing debt. Ultimately, we think it is more likely than not the provision remains mostly as-is when it works its way through the Congress (the provision raises $172 billion over 10 years).

**The easiest path most times is to adjust existing policies on the table**. One rule of thumb when trying to be predictive around where provisions will end up in a final version of the bill: it tends to be easiest for lawmakers to dial up or dial down certain provisions. And it tends to be harder to strip out provisions entirely, and it's harder still to add new provisions that were not included originally.

***Industry Focus: Financial Services***

**Ed Groshans (202) 629-0025 or egroshans@heightllc.com**

**Financial Services Companies and Banks**

The tax bill will significantly benefit financial services companies with net interest income. Banks are one industry segment that pays significant federal cash taxes. The limitation on interest expense deductions is defined as net interest expense. This should not affect most financial services companies because they have net interest income. There is a small offset as banks over $10 billion will not be able to deduct FDIC deposit insurance assessments from their tax filings. However, the lower corporate tax rate materially offsets this change and banks across the board would post higher earnings and EPS compared to the current corporate tax structure (**Figure 1**). There was some concern that an Obama-era bank tax could be incorporated into the bill as a revenue raiser, but we did not find this tax in the bill and think it is unlikely to surface at a later stage in the debate.

**SALT and Mortgage Interest Caps**

The Census Bureau reported that the median and average median price of homes sold in the U.S. were $319,700 and $385,200, respectively, as of September 2017. *CBS News* reported the states with the most expensive median home prices (**Figure 2**). Both reports showed that the median home prices are below $500,000. The National Association of Realtors (NAR) and the National Association of Home Builders (NAHB) issued statements in opposition to yesterday's draft bill even though the vast majority of homes in the U.S. would not be affected by the mortgage interest deduction cap of $500,000.

The cap on state and local taxes (SALT) of $10,000 combined with the cap on mortgage interest deduction on mortgages at $500,000 will affect states that vote primarily Democratic or lean Democratic. According to the *CBS News* data, nine of the 11 states with highest median home prices are Democratic-leaning states and only two are Republican-leaning states (**Figure 2**). Using median home prices and average state property taxes show that for single filers, home ownership would provide a higher tax shelter in nine out of 11 states as well as based on the average price and average state tax rate. However, for joint filers, the new $24,000 standard deduction would be the best option every time (**Figure 3**). This is the issue for NAR. The expectation is that potential homebuyers benefitting from the new higher standard deduction would not be incentivized to purchase a home because they would obtain a tax benefit. In our view, both NAR and NAHB are more concerned about reduced sales of high-end homes, which would reduce commissions for realtors and lower revenues for builders. We can see this change negatively affecting homebuilders, specifically luxury builders like Toll Brothers (**TOL**).

**Figure 1. Estimating Tax Changes on ZION's 3Q17 earnings**

| ZION $ in millions | 3Q17 | Tax Rate Adjustment | Change | Tax Rate & FDIC Adj | Change |
|---|---|---|---|---|---|
| | | | | | |
| Pretax Income | $ 243 | $ 243 | | $ 243 | |
| FDIC Assesment | $ - | $ - | | $ 15 | |
| Adj Pretax Income | $ 243 | $ 243 | $ - | $ 258 | $ 15 |
| | | | | | |
| Tax Rate | 34.2% | 20.0% | | 20.0% | |
| Taxes | $ 83 | $ 49 | $ (34) | $ 52 | $ (31) |
| | | | | | |
| Net Income | $ 160 | $ 194 | $ 34 | $ 206 | $ 46 |
| FDIC Assesment | $ - | $ - | | $ 15 | 23.9% |
| Adj Net Income | $ 160 | $ 194 | $ 34 | $ 191 | $ 31 |
| | | | | | |
| Prefffereds/Other | $ 8 | $ 8 | | $ 8 | |
| Net to Common | $ 152 | $ 186 | $ 34 | $ 183 | $ 31 |
| | | | | | |
| Diluted Shares | 209.1 | 209.1 | | 209.1 | |
| EPS | $ 0.72 | $ 0.89 | $ 0.17 | $ 0.88 | $ 0.16 |
| EPS Chg % | n.a. | | 23.8% | | 21.8% |

*Source: ZION 3Q17 earnings release, Height Securities estimates.*

**Figure 2. States with the Most Expensive Median Home Prices**

| State | Median Home Price | Average State Taxes | Political Leaning |
|---|---|---|---|
| Washington D.C. | $459,498 | $ 4,915 | Democratic |
| Hawaii | $430,000 | $ 2,489 | Democratic |
| California | $360,000 | $ 4,783 | Democratic |
| New York | $317,191 | $ 7,013 | Democratic |
| Massachusetts | $312,250 | $ 5,513 | Democratic |
| New Jersey | $275,000 | $ 8,103 | Democratic |
| Alaska | $261,250 | $ 3,225 | Republican |
| Colorado | $250,000 | $ 2,046 | Leans Democratic |
| Washington | $245,000 | $ 4,767 | Democratic |
| Delaware | $230,250 | $ 1,526 | Democratic |
| Utah | $227,668 | $ 1,948 | Republican |

*Source: CBS News, , USA Today, Height Securities.*

Ultimately, we think additional changes are coming to treatment of the SALT deduction whether targeting property taxes specifically or making the provision more lenient around sales and income-side tax deductions as well. These changes will likely begin to be explored publicly next week during Ways and Means Committee consideration of the measure. We don't expect the issue to be litigated much on the Senate side, where the politics are such that no Republicans come from districts that benefit from the SALT deduction. But we do expect that the final version of the SALT treatment that can pass the House as soon as next month will represent a final compromise that the Senate will ultimately maintain in order to ensure votes on a final bill in the House.

The cap on mortgage interest deduction may affect banks focused on originating jumbo mortgages, notably JPMorgan Chase (**JPM**). There may be some slowdown in jumbo originations due to this change. The concern of reduced home sales also affected Home Depot (**HD**) and Lowes (**LOW**). The thought process is that a slowdown in sales of $500,000+ homes will reduce home refurbishments and renovation, which would lower home improvement sales.

We think yesterday's proposal represents the ceiling of possible policy changes, with the floor being no change to the current $1 million deduction cap. We believe the immediate and negative reaction by housing advocacy organizations discussed above will put pressure on policymakers to walk back this provision. Additionally, the Unified Framework document that previewed tax reform in late September messaged that there would be no change to the mortgage interest deduction, which we think indicates a sensitivity here by Leadership to ensure tax code changes do not inflict significant and adverse effects on homeownership.

**Figure 3. Proposed $24,000 Standard Deduction Higher than Itemizing in High-Cost States**

| | Median U.S. Home Price | Average U.S. Home Price | D.C. Home Price | Hawaii Home Price | California Home Price | New York Home Price | Massachusetts Home Price |
|---|---|---|---|---|---|---|---|
| Home Price | $ 319,700 | $ 385,200 | $ 459,498 | $ 430,000 | $ 360,000 | $ 317,191 | $ 312,250 |
| Interest Rate | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% |
| | | | | | | | |
| Interest | $ 13,587 | $ 16,371 | $ 18,275 | $ 18,275 | $ 15,300 | $ 13,481 | $ 13,271 |
| | | | | | | | |
| State Taxes | $ 3,296 | $ 3,296 | $ 4,915 | $ 2,489 | $ 4,783 | $ 7,013 | $ 5,513 |
| | $ 16,883 | $ 19,667 | $ 23,190 | $ 20,764 | $ 20,083 | $ 20,494 | $ 18,784 |
| | | | | | | | |
| Single Deduction | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 |
| | Itemized | Itemized | Itemized | Itemized | Itemized | Itemized | Itemized |
| | | | | | | | |
| Joint Deduction | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 |
| | Deduction | Deduction | Deduction | Deduction | Deduction | Deduction | Deduction |

| | New Jersey Home Price | Alaska Home Price | Colorado Home Price | Washington Home Price | Delaware Home Price | Utah Home Price |
|---|---|---|---|---|---|---|
| Home Price | $ 275,000 | $ 261,250 | $ 250,000 | $ 245,000 | $ 230,250 | $ 227,668 |
| Interest Rate | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% |
| | | | | | | |
| Interest | $ 11,688 | $ 11,103 | $ 10,625 | $ 10,413 | $ 9,786 | $ 9,676 |
| | | | | | | |
| State Taxes | $ 8,103 | $ 3,225 | $ 2,046 | $ 4,767 | $ 1,526 | $ 1,948 |
| | $ 19,791 | $ 14,328 | $ 12,671 | $ 15,180 | $ 11,312 | $ 11,624 |
| | | | | | | |
| Single Deduction | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 |
| | Itemized | Itemized | Itemized | Itemized | Deduction | Deduction |
| | | | | | | |
| Joint Deduction | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 | $ 24,000 |
| | Deduction | Deduction | Deduction | Deduction | Deduction | Deduction |

*Source: CBS News, U.S. Census Bureau, USA Today, Tax Reform Bill, Height Securities.*

## Insurance Companies

The tax draft would change the deferred acquisition costs (DAC) for life insurance policies. Current tax law permits DAC to be amortized at a rate of 1.75% of net premiums per year for annuity contracts, 2.05% of net premiums per year for group life insurance contracts, and 7.7% of net premiums per year for all other life insurance policies. The tax reform bill appears permits two DAC schedules. Group life insurance policy DAC will be amortized at a rate of 4% of net premiums per year and all other policies will be amortized at 11% of net premiums per year, which appears to include annuities. The change to the DAC amortization schedule makes it unclear if the reduced tax rate will offset what appears to be higher DAC expenses (**Figure 4**). It will depend on the current effective tax rate of insurers as well as the mix of life insurance policies (i.e. annuities, whole life, group, etc.).

The American Council of Life Insurers (ACLI), the trade group that represents the life insurance industry, has three key issues it lobbies—computation of life insurance ex reserves, adjustment for the change for computing reserves, and modification of rules for life insurance proration for purposes of deterring the dividend received deduction. Yesterday's draft included all those issues. In combination, the changes represent a tax increase on the insurance industry of $17 billion over 10 years. We believe despite the power of the insurance lobby in Washington, there will be little change to the provisions. With the Republicans so close to the $1.5 trillion revenue target, there is going to be strong pressure *not* to remove these provisions.

**Figure 4. Estimating Tax Changes on PRU's Earnings**

| | | Increase in DAC | | | | Increase in DAC | | |
|---|---|---|---|---|---|---|---|---|
| **PRU** | **3Q17** | **10%** | **25%** | **50%** | **2Q17** | **10%** | **25%** | **50%** |
| DAC | $ 653 | $ 718 | $ 816 | $ 980 | $ 755 | $ 831 | $ 944 | $ 1,133 |
| Pretax Income | $ 3,021 | $ 2,956 | $ 2,858 | $ 2,695 | $ 608 | $ 533 | $ 419 | $ 231 |
| Taxes | $ 800 | $ 591 | $ 572 | $ 539 | $ 125 | $ 107 | $ 84 | $ 46 |
| | | | | | | | | |
| Tax Rate | 26.5% | 20.0% | 20.0% | 20.0% | 20.6% | 20.0% | 20.0% | 20.0% |
| | | | | | | | | |
| Net Income | $ 2,221 | $ 2,365 | $ 2,286 | $ 2,156 | $ 483 | $ 426 | $ 335 | $ 184 |
| Change $ | | $ 144 | $ 65 | $ (65) | | $ (57) | $ (148) | $ (299) |
| Change % | | 6% | 3% | -3% | | -3% | -7% | -13% |
| | | | | | | | | |
| | | Increase in DAC | | | | Increase in DAC | | |
| **PRU** | **1Q17** | **10%** | **25%** | **50%** | **4Q17** | **10%** | **25%** | **50%** |
| DAC | $ 724 | $ 796 | $ 905 | $ 1,086 | $ 711 | $ 782 | $ 889 | $ 1,067 |
| Pretax Income | $ 1,742 | $ 1,670 | $ 1,561 | $ 1,380 | $ 317 | $ 246 | $ 139 | $ (39) |
| Taxes | $ 395 | $ 334 | $ 312 | $ 276 | $ 35 | $ 49 | $ 28 | $ (8) |
| | | | | | | | | |
| Tax Rate | 22.7% | 20.0% | 20.0% | 20.0% | 11.0% | 20.0% | 20.0% | 20.0% |
| | | | | | | | | |
| Net Income | $ 1,347 | $ 1,336 | $ 1,249 | $ 1,104 | $ 282 | $ 197 | $ 111 | $ (31) |
| Change $ | | $ (11) | $ (98) | $ (243) | | $ (85) | $ (171) | $ (313) |
| Change % | | -1% | -4% | -11% | | -4% | -8% | -14% |
| | | | | | | | | |

*Source: PRU 3Q17 financial supplement, Height Securities estimates.*

*Industry Focus: Healthcare and Technology*

**Stefanie Miller (202) 629-0039 or smiller@heightllc.com**
**Shrey Verma (202) 629-0038 or sverma@heightllc.com**

**Pharma**

Section 3401 would repeal the tax credit extended to pharmaceutical companies to offset research and development expenses for orphan (novel) drugs. The JCT estimates the value of the tax credit to be $54 billion between 2018 and 2027. Since the credit is used for clinical trial expenses for diseases affecting fewer than 200,000 Americans, it would impact drug makers with orphan drugs in the development pipeline that have not yet been approved by the Food and Drug Administration (FDA). Roche (emicizumab), AstraZeneca (tremelimumab and acalabrutinib), Novartis (CTL019), and AbbVie (veliparib) are among these drug makers. In our view, this provision is likely to remain in the final bill because it a valuable offset and pharmaceutical companies have other mechanisms to recoup the loss of the tax credit, including charging higher prices for approved orphan drugs during their seven-year market exclusivity period.

**Tech & Pharma**

The 10% global minimum tax rate envisioned in the House draft would represent a tax increase on companies that pay extremely low effective tax rates, including those heavily reliant on income from IP held overseas such as many companies in the tech and pharma sectors. We continue to expect the final bill will include a global minimum tax that stays close to a 10% rate.

**Medical Expenses Deduction**

Section 1308 would repeal the personal income tax deduction for medical expenses exceeding 10 percent of a person's income. IRS data show that in 2015, more than 9 million claimed approximately $87 billion in medical expenses on their tax returns. The Department of the Treasury estimates this saves $144.4 billion between 2018 and 2027. This provision is not expected to have an impact on overall healthcare utilization because filers who claim the deduction tend to have serious medical needs or require long-term care. While this provision helps offset the cost of increasing the standard deduction, we could see this deduction survive in some form as part of a final bill. Earlier this year, Republicans advocated for expanding the deduction to expenses exceeding 5.8 percent of income as part of Affordable Care Act (ACA) repeal efforts. The deduction is important to individuals who pay for health insurance premiums with post-tax dollars, especially the self-employed and early retirees facing high health insurance premium increases for 2018 in the unsubsidized individual insurance market.

**MSAs**

Section 1311 repeals the deduction and exclusions for contributions to Archer Medical Savings Accounts (MSAs), favoring instead rolling over MSA funds to health savings accounts (HSAs) that would remain tax-free. The provision is expected to generate negligible revenue but it would shift demand to HSAs, which is a Republican policy priority.

**Employer-sponsored Health Insurance / ACA Excise Taxes**

The bill does not limit or repeal the tax exclusion for employer-sponsored health insurance or repeal ACA-related excise taxes on medical devices, health insurers, high-cost health insurance, and pharmaceutical products. We expect to continue to see headlines around efforts to repeal the individual mandate through the tax bill, but we do not think policymakers will include that in final legislation.

*Industry Focus: Energy & Industrials*

**Katie Bays (202) 629-0021 or kbays@heightllc.com**

*Our Energy Team Quick Take:*

The House GOP tax reform proposal appears largely constructive for energy companies, including utilities, oil and gas producers, and midstream companies, though it is also likely to create some confusion for these businesses as companies analyze how new rates, rules, and exemptions apply. Prominently, utility companies are carved out of many of the significant changes in the proposal, including changes to net interest expensing and up-front capital expensing. Key tax privileges for oil and gas drillers, like the ability to claim intangible drilling expenses, are expected to remain in the tax code. Master Limited Partnerships preserve their tax privileged status. However, with a lower corporate rate and the new pass-through rate, MLPs lose some of their appeal. Renewable energy companies, particularly wind energy companies, see a hit in the tax plan, as Republicans proposed lowering the value of the production tax credit to $15/MWh from $24/MWh.

**Regulated Utilities and Merchant Power Producers**

It appears that the House GOP tax writers got the message from **regulated utilities**. As most regulated utility companies have repeatedly stated (most recently, Tom Fanning, Southern Company CEO (**SO**) on their earnings call this week), the ability to expense net interest and depreciate capital expenditures over many years is critical to rate making processes and laws that govern utility rate-setting. In our interpretation, these companies should be able to continue to operate in a similar manner as they do currently, with unlimited ability to deduct interest expense and to elect depreciation schedules for capital investments. Utilities will endure a change to their revenue requirements, however, as utility commissions adjust the revenue requirement down to reflect the new 20% corporate tax rate. This should reduce cash flow from regulated businesses to the parent company across the board, as a 10.25% pre-tax return on equity (6.7% assumes after tax ROE at the current rate) should fall to about 8.5% pretax at the new 20% corporate rate. These changes would not happen right away – utility ratemaking usually occurs over several year intervals, and utilities should expect to continue earning on the higher ROE for the immediate term even though they may have to issue refunds to customers in future years for over-earning.

**Hybrid electric utilities**, like FirstEnergy (**FE**), Exelon (**EXC**), and NextEra (**NEE**) are in a bit of an uncertain spot. Clearly, the law intends to allow regulated public utility companies to continue to expense interest and depreciate capex, and these companies' regulated utility subsidiaries will continue to do so. But what about their unregulated businesses? Presently, we believe that the unregulated (or merchant) subsidiaries of hybrid utilities will have to abide by the laws that govern other non-utility businesses, meaning full capex expensing. This might not be a bad thing for some companies – FE's FirstEnergy Solutions subsidiary would be able to pass bigger losses through to parent FE in this arrangement, as future capex, which is substantial, can be fully expensed rather than depreciated over many years. Predominantly **merchant power generators** like **NRG**, Dynegy (**DYN**), Vistra (**VST**), and Calpine (**CPN**) will likely be subject to full capex expensing and the limit on interest deductibility. This may pose a problem in the near-term for these heavily leveraged companies – while the merchant generators are engaging in strategies to reduce leverage, DYN, NRG, and CPN all appear to test the limit on 30% net interest expensing (though the combined DYN-VST entity would not). The lower corporate tax rate is a valuable offset. However, limits on net operating losses (NOLs), which would be restricted to 90% of the taxpayer's taxable income (Section 3302), suggest that the companies may not capture all the write-off benefits to the extent that they exceed the new NOL limit. Some of the companies' most valuable assets are the NOLs accumulated over several tough years, which don't appear to be in jeopardy (retroactively), but the stand-alone entity ability to continue to accrue NOLs appears limited in the proposal.

**Proposed Changes to the Renewable Energy Tax Credits**

The big surprise (from our point of view) in the House bill is the proposal to drop the value of the **wind energy** Production Tax Credit (Section 3501) from $24/MWh in current law to $15/MWh for projects that start construction after November 2, 2017. The tax plan derives about $12.3 billion from this proposed change, which would substantially reduce the economics of a wind facility (the PTC is also claimed by facilities that produce electricity through closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy and by refined coal producers). Already, Iowa Senator Chuck Grassley, a Republican, has come out against the proposed change to the PTC. The PTC is already expected to phase out through 2019, and we believe that tax writers may be persuaded to back off the immediate reduction in value for the credit. However, the House also proposed to restrict PTC qualification to facilities that can show "a continuous program of construction," more restrictive than the existing safe harbor provision that allows facilities to claim the credit that applied when they "started construction". Perhaps this change, which we also see in the law's proposed treatment of the **Solar Investment Tax Credit** (for solar and geothermal, section 3502), would remain in place. This allows the tax bill to derive some revenue from the PTC and ITC changes (the ITC change is worth $1.2 billion), without re-litigating the phase-out for either program.

Renewable energy companies and utilities with significant renewable portfolios, like NextEra (**NEE**) and ALLETE (**ALE**), took a hit as news came out that House proposed cutting the PTC. The real losers may be the **YieldCo** companies like Patter Energy (**PEGI**), NRG Yield (**NYLD**), and Terraform Power (**TERP**). YieldCos, or "synthetic MLPs," depend upon several tax treatments that are not likely to remain in the law. First, the companies use the PTC and ITC to offset revenue generated by wind and solar projects. Changes to these programs, however modest (like eliminating the Safe Harbor provision), would impair YieldCos' ability to offset revenue from future projects. Second, the companies use depreciation schedules to offset revenue from power sales, and they would now have to manage carrying forward losses associated with full capex expensing. Finally, limits on carry-forward of Net Operating Losses (limited in the law to 90% of the company's taxable income), would likely restrict the companies from taking full advantage of their interest deductions and capital expenditures.

## Advanced Nuclear Production Tax Credit

Southern Company (**SO**) can rest easy – the House wants to give them their **Advanced Nuclear Production Tax Credit** for their under-construction Alvin Vogtle nuclear generating units. This is no surprise – the House passed the nuclear PTC in June, but the language in the new bill gives SO a bit more wiggle room. Now, beginning after 2021 (when the law is technically supposed to expire), the Treasury Secretary would have the ability to re-allocate any national megawatt capacity that remains unused under the 6,000 MW cap to qualifying new facilities, therefore allowing Vogtle to claim the credit for eight years after the units start operating (expected mid-2020s). SCANA (**SCG**) was originally expected to seek the credit for the VC Summer Nuclear unit, as was Duke Energy (**DUK**) for the proposed HF Lee nuclear units, but neither company is currently planning to construct the power plants.

## Oil and Gas Producers

**Oil and gas exploration and production companies** should see a lot to like in this new bill. Yes, they will lose some of their fringe tax credits, for instance the credit for production from marginal wells and the credit for enhanced oil recovery. The big hit comes from the repeal of the Section 199 domestic manufacturing deduction, which is repealed across the board. However, two major tax credits will remain: smaller E&P companies can continue to claim their percentage depletion tax credit, and larger E&Ps that depend on Intangible Drilling Costs (IDCs) to reduce their tax liabilities will continue to claim this credit. IDCs, in particular, are a frequent subject of discussion for tax reform, but the House GOP appeared more interested in symbolic cuts to E&P tax credits (like the marginal wells and EOR) than actually stripping producers of key credits. Don't expect this to change – while the major focus for tax writers remains finding enough revenue to offset deep tax cuts, pulling in a change to IDCs or percentage depletion at this point would probably be more difficult than if it had been introduced in yesterday's text.

## Midstream and MLPs

Another capital-intensive industry, the midstream sector should find a lot to like in the GOP plan. Large **midstream companies organized as C-corporations**, like Kinder Morgan (**KMI**), Williams (**WMB**), and Enbridge (**EEQ**), all benefit from the lower tax rate and up-front capex expensing. Limits on carry-forward of net operating losses, which would be restricted to 90% of the taxpayer's taxable income (Section 3302), may create some new challenges as companies seek to maximize their ability to claim deductions and losses.

Additionally, midstream businesses organized as **Master Limited Partnerships** (MLPs) may continue to access a tax-advantaged pass-through structure. The tax bill's new 25% "pass-through" tax rate, which is applicable to all entities organized as pass-throughs, and the lower 20% corporate tax rate makes the MLP structure somewhat less attractive in the tax proposal. Partnerships are subject to the same limit on net interest deductions as most taxpayers – the deduction claimed must not exceed 30% of the company's "adjusted taxable income", or the business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion. In addition to their interest expense, MLP companies would likely be required to fully expense capital expenditures in the year in which they occur, and they would lose the ability to use depreciation schedules.

***About the pass-through rate:*** the House GOP proposes a fundamentally new tax rate for pass-through entities, including partnerships. Distributions from pass-through entities would be taxed at a lower rate (25%) – though distributions would be subject to "the 70/30 rule," which limits the application of the lower rate to only 30% of the distribution or more if the pass-through can prove through "facts and circumstances" that more than 30% of the distribution comes from capital investment. This should be no problem for midstream MLPs, since they obtain very little revenue through the provision of services and generate most revenue through capital investment. However, that pass-through tax rate, while advantageous for small businesses, is not necessarily more attractive to the C-Corp General Partner that owns the MLP, who now can access the lower 20% corporate rate. Entities like **EEQ**, **WMB**, Plains GP Holdings (**PAGP**), and other C-Corps with MLP subsidiaries will have to determine whether they prefer to retain their pass-through subsidiaries (like **EEP**, **WPZ**, and **PAA**), or roll the MLP up into the C-Corp now that their tax rate is reduced. We suspect that the partnership will remain attractive, however, for two big reasons. First, the companies would not appear to be impacted by the law's proposed limits on carry-forward of net operating losses. Second, the MLP would retain the ability to pass net interest deductions up to the GP parent, even if the parent exceeded the 30% limit on net interest deductions. Thus, entities like EEQ and WMB could actually claim losses from net interest in excess of 30% if the additional losses (or the "excess amount", in the law) come from the MLP. This likely will continue to make the MLP structure attractive for midstream companies despite the relatively unique application of the new pass-through rate.

### *Next Steps*

We think a tax package is still likely to become law by roughly end of 1Q 2018. Below we lay out next steps between now and the end of the CY 2017. But as we've written, any delay will likely have a cascading effect and push the entire process into the early months of 2018. We continue to believe it's likely that such slippage occurs. However, if Congress can continue to function at such a unified and rapid pace as we've seen with the budget process, such an ambitious timeline is possible albeit unlikely.

**Today**

House Ways & Means Committee Chairman Kevin Brady (R-TX) will release a slightly revised version of the bill around noon today.

**Week of November 6**

On Monday, the House Ways and Means Committee begins to mark-up the bill. The markup will take a couple of days. Between now and then there may be negotiations about and changes to the most controversial provisions in order to try and win support among interest groups and votes in the House. At the markup, expect lots of amendments offered by Democrats, but with 24 Republicans and just 16 Democrats on the Committee, few of them will be approved.

We also expect to the see the Senate Finance Committee unveil its version of a tax bill later in the week. The themes of corporate tax cuts and individual tax simplification will be the same, but the details are going to be different.

**Week of November 13**

During the week of November 13, the bill is expected to be on the House floor – if the votes are there. If not, we'll watch closely to see how Republican leadership changes the bill in order to get 218 votes. Also this week we expect the Senate Finance Committee mark-up its bill.

In our view, this is the first real step in which the process could hit a snag. It's not clear whether the current bill can get 218 votes in the House, and there's a chance that floor consideration could lead to one of the mini failure events we outline in our October 25 report.

**November 18 - 30**

While the House and Senate are scheduled to be on Thanksgiving recess beginning Friday the 18th, it's possible that either chamber could stay in session that weekend (or later) in order to work on the bill.

It's too early to say whether the Senate will have the votes. If the Senate doesn't have 50 votes for a bill that week, the Senate would be expected to use this time to make further changes to its bill.

**December**

If both chambers have passed their own bills, bicameral negotiations will be needed to hammer-out the differences. In theory, this could occur prior to the Christmas holiday but as we write above we think more likely there is slippage into early next year.

***Overview of the House Draft***

Key provisions of H.R. 1, the Tax Cuts and Jobs Act (see the draft HERE with section-by-section summary HERE):

**Individual provisions**

- Four marginal brackets with an effective fifth bracket at 0% along the following schedule for married taxpayers filing jointly (unmarried / married filing separately rates are half the thresholds for married filing jointly except the 35% bracket which is a $200,000 threshold):
  - 0% rate on income at or below $24,000
  - 12% on subsequent income at or below $90,000.
  - 25% on subsequent income at or below $260,000.
  - 35% on subsequent income at or below $1 million.
  - 39.6% on income greater than $1 million
- Standard deduction / personal exemption:
  - $12,000 for individuals, $24,000 for married (effective in 2018)
  - Eliminates the personal exemption (set at $4,050 in 2017) after 2017
- Child tax credits:
  - $1,600 (up from $1,000) child tax credit – refundable to $1,000 and indexed (chained CPI) up to the $1,600 cap
  - $300 credit for each parent and non-child dependent to families (phased out over six years)
- Mortgage interest deduction:
  - No change for existing mortgages
  - For new mortgages, interest deduction capped at $500K (current cap is $1M)
- Principle residence sale exclusion:

    - Rule changes from “principal residence for 2 of 5 years” to 5 of 8 years.

- State and local tax (SALT) deduction:
    - Itemized deduction of state/local income or sales tax not permitted
    - Can deduct up to $10K in state and local property taxes
- Estate tax doubles the exemption for first six years, repeals after that
    - Top rate lowered from 40% to 35%
- Individual AMT fully repealed
- Other deductions and credits:
    - Repeal adoption credit
    - Repeal deductions for tuition and student loan interest and exclusions for tuition reductions and employer-provided education assistance
    - Repeal Pease limitation on itemized deductions
    - Repeal deduction for personal casualty losses, medical expenses, out of pocket employee expenses and various other minor deductions
    - Repeal of various minor exclusions, including moving expenses
- Provisions left largely unchanged:
    - Retirement / 401(k)s
    - Capital gains and dividends
    - Carried interest

**Corporate provisions:**

- Corporate rate reduced to 20% beginning in 2018 and permanently
- Corporate AMT repealed
- 100% cap-ex expensing through December 31, 2022
- Disallowance of interest expense in excess of 30% of adjusted taxable income, businesses with gross receipts below $25M exempt

- Limit NOLs to 90% of taxable income
- Like-kind exchanges limited to real property (no tangible personal property)
- Repeal PABs, other bond programs
- Repeal of Sec. 199 domestic manufacturing deduction
- Denial of deduction for entertainment expenses, fringe benefits and transportation benefits
- Reduce PTC rate to 1.5 cents/kwh and harmonize phase out of various ITCs
- Pass-throughs:
  - Maximum business income rate of 25%
  - Rate determined by either 70/30 rule or facts and circumstances based on capital investment
- International provisions:
  - Shift to territorial system
  - Deemed repatriation over eight years at the following rates:
    - 12% on liquid assets
    - 5% on illiquid assets
  - Global minimum tax at 10 percent on US foreign sourced income
  - 20 percent surtax on all related party payments (other than interest) from a US entity to a foreign entity
  - Inclusion of 50% of foreign excess returns (those over 7% plus federal short-term rate) in Subpart F regime
  - Limitation on interest expense of US subsidiaries to the extent share of group interest expense exceeds 110% of group EBITDA

**RISKS**

The legislative and regulatory agendas are subject to change at the discretion of leadership. Unprecedented economic conditions could instigate unanticipated and/or sweeping shifts in policy. Predicting the future is a hazardous endeavor and economic / market forecasting is an imprecise science. Actual outcomes may differ substantially from our forecasts. The predictions and opinions expressed herein are subject to change at any time.

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**ANALYST CERTIFICATION**

I, Stefanie Miller, Katie Bays, Ed Groshans, Shrey Verma, and Trevor Hanger certify that (i) the recommendations and opinions expressed in this research report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers discussed herein and (ii) no part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report.

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