TRUMP ADMINISTRATION, CONGRESS PUBLISH FRAMEWORK FOR TAX REFORM

CAPITOL CORNER

TIGHT LABOR MARKET POSES INCREASING CHALLENGE FOR MIDDLE MARKET

MIDDLE MARKET CONFIDENCE RETREATS
ABOUT THE AUTHORS

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Joe Brusuelas, Chief Economist, RSM US LLP
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In our estimation, the probability of any substantial tax reform or tax cuts, at least for 2017, is rapidly diminishing even after the Sept. 27 release of the joint framework for possible legislation. If tax legislation is passed at all, it will likely be a first half of 2018 event, with some members of Congress probably pushing for retroactivity to Jan. 1, 2018.

If anything gets done, either this year or next, it will most likely be more modest tax cuts directed at the corporate sector with minor adjustments for individual households.

Meanwhile, priority will be given to reducing the corporate rate based on congressional assumptions that the biggest bang for the buck lies with targeting growth, productivity and job creation. Despite the proposed doubling of the standard deduction for individuals and married couples, the optics on lifting taxes (to 12 percent from 10 percent) for those at the lower portion of the income ladder will be difficult to overcome.

The Committee for a Responsible Federal Budget estimates that the proposed framework would increase the U.S. debt by about $2.2 trillion over 10 years. Based on our estimates of the cost of reducing corporate and individual rates, the true cost would likely be well above $2 trillion with growth increasing between 0.2 and 0.6 percent on an annual basis over that span, the majority of it clustered in the first three years after passage.

The deficit, interest rates and the Fed

It is important to note that if initial estimates of the size of the budget deficit are understated, the middle market should anticipate more aggressive monetary policy tightening by the Federal Reserve (Fed) and for interest rates at the longer end of the maturity spectrum to increase.

The current forecast from the central bank is that the market should anticipate an additional increase of 100 basis points in the policy rate by the end of 2018, and that is before any potential tax cut. The consensus forecast on the 10-year treasury is that it will average 2.96 percent in 2018. Both the Fed’s and the market’s rate forecast at the short and long end of the treasury curve will surely increase if the offsets to pay for the tax cuts are watered down.

Political fallout

The political fallout from the two Affordable Care Act repeal and replace attempts this year is that Arizona Senator John McCain has called for regular order in the Senate and a bipartisan approach to broader tax reform or tax cuts. Due to the narrow majority the GOP holds in the Senate, the difficulty in moving tax legislation through Congress in a way that satisfies the party’s different factions increases exponentially if regular order is imposed.

If regular order is followed, special interests inside the beltway will probably try to preserve current tax entitlements—especially the state and local tax deductions on federal filings—and shape the legislation in a way that would likely make it too expensive for the budget hawks inside the GOP and its Freedom Caucus to support. Despite the need for tax reform, there is a non-trivial possibility that nothing will come from any of this.
The following is a quick thumbnail sketch of the GOP tax plan:

**INDIVIDUAL**

- No income tax on the first $12,000 of income for individual filers ($24,000 for married)
- Individual tax rates of 12 percent, 25 percent and 35 percent with the option of adding a fourth, higher income tax bracket
- Retention of the mortgage interest and charitable deductions and elimination of most other itemized deductions
- Retention of certain tax credits for higher education, work incentives and retirement security benefits
- Repeal of the individual alternative minimum tax (AMT)
- Significant increase of the Child Tax Credit and a new $500 non-refundable credit for non-child dependents
- Repeal of the estate tax and the generation-skipping transfer tax

**BUSINESS**

- 20 percent corporate tax rate with an “aim to eliminate” the corporate AMT
- 25 percent rate for certain business income of “small and family-owned business[es] conducted as sole proprietorships, partnerships and S corporations”
- Immediate expensing of new investments in “depreciable assets other than structures made after Sept. 27, 2017” (applies to investments made in the first five years after the proposal takes effect, and possibly for longer)
- Partial limitation of deduction for net interest expense incurred by C corporations
- Repeal of many business deductions, including the domestic production activities deduction
- Retention of existing provisions governing low-income housing tax credits and research tax credits

**INTERNATIONAL**

- Move to a territorial system
- Accumulated offshore business income taxed at different rates for illiquid assets and cash or cash equivalents
- Committees to consider measures to prevent erosion of the U.S. tax base

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**Significant Tax Expenditure**

<table>
<thead>
<tr>
<th>Individual Code</th>
<th>Estimated Cost 2018-2027: Billions ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusion of employer provided health insurance</td>
<td>2,334</td>
</tr>
<tr>
<td>Exclusion of retirement savings</td>
<td>2,935</td>
</tr>
<tr>
<td>State and local tax deductions</td>
<td>1,270</td>
</tr>
<tr>
<td>Mortgage interest deductions</td>
<td>896</td>
</tr>
<tr>
<td>Charitable giving deduction</td>
<td>777</td>
</tr>
<tr>
<td>Capital gains at death</td>
<td>624</td>
</tr>
<tr>
<td>Exclusion of capital gains from home sales</td>
<td>582</td>
</tr>
<tr>
<td>Exclusion of social security benefits</td>
<td>471</td>
</tr>
<tr>
<td>Exclusion of municipal bond interest income</td>
<td>423</td>
</tr>
<tr>
<td>Medical expense deduction and health savings accounts</td>
<td>352</td>
</tr>
<tr>
<td>Exclusion of income from life insurance policies</td>
<td>334</td>
</tr>
<tr>
<td>Child tax credit</td>
<td>237</td>
</tr>
<tr>
<td><strong>Corporate</strong></td>
<td><strong>1,551</strong></td>
</tr>
</tbody>
</table>

**Source:** RSM, U.S. Office of Management and Budget, Congressional Budget Office
Inside the numbers

The economics of the tax plan are straightforward. The plan, which resembles the GOP’s House Blueprint—minus the border adjustment tax (BAT)—is an attempt to shore up the integrity of the U.S. tax base by providing incentives to reduce tax avoidance, lowering taxes on corporations to stimulate productivity-enhancing investment, and simplifying taxes for individual households.

With the loss of the BAT, the House Ways and Means Committee and the Senate Finance Committee will have to do some very heavy lifting on imposing a territorial system that eliminates double taxation for firms that operate abroad while addressing the deferral of income for foreign corporations. That would mean a loss of $1.5 trillion in government revenues during the next decade.

For each point in deductions of the corporate tax rate, the loss in government revenues is about $110 billion. So a reduction in the corporate rate to 20 percent from 35 percent would cost about $1.65 trillion over the next 10 years. The cost of reducing the rate of taxation by 1 percent on all ordinary income would be about $800 billion, the cost for those in the 28 percent bracket $170 billion, and the cost for those in the 35 percent bracket $70 billion, all over a 10-year time span. Thus, the total tax cut, before eliminations of tax expenditures, is going to be nearly $5.8 trillion.

Bye-bye, deductions

Because the tax cut proposal is so expensive, there will need to be offsets via the elimination of many, if not most, of the tax deductions that litter the tax code. With only about 15 percent of those deductions located in the corporate tax code, this means targeting tax deductions in the individual code, which will be politically difficult at best, and which may result in a significant scaling back of the tax plan as it works through the House and Senate.

So what tax deductions will likely be targets for elimination? First, state and local tax deductions on federal filings would provide a $1.27 trillion offset. This will directly affect high-tax states, such as California, Illinois and New York. Without the elimination of state and local tax deductions, the plan, in its current form, is simply a non-starter.

Second, there is $2.9 trillion over the 10-year period located in the exclusion of employer-provided health insurance from taxable income that could be tapped to offset the cost of the GOP tax plan. However, this would be politically difficult. It is important to note that the “Cadillac Tax” embedded in the 2010 Affordable Health Care Act on lavish insurance plans has been postponed until 2020 due to its general unpopularity among both political parties.

Republican tax plan

<table>
<thead>
<tr>
<th>Category</th>
<th>Current law</th>
<th>GOP plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes</td>
<td>Seven brackets of 10%, 15%, 25%, 28%, 33%, 35%, 39.6%</td>
<td>Three brackets of 12%, 25% and 35%</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>$6,350 for singles, $12,700 for married couples</td>
<td>Increased deductions to $12,000 for singles and $24,000 for married couples</td>
</tr>
<tr>
<td>Alternative minimum tax</td>
<td>Limited tax benefits for higher income earners</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Estate tax</td>
<td>Taxes estates property valued at more than $5.5 million</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Corporate taxes</td>
<td>Top rate of 39%</td>
<td>Top rate of 20% for corporations and 25% for pass-through entities</td>
</tr>
<tr>
<td>Tax deductions</td>
<td>Numerous tax expenditures allow individual households and corporations to reduce tax burden</td>
<td>Eliminates most tax expenditures except those for mortgage interest and charitable giving</td>
</tr>
</tbody>
</table>

Source: RSM and Internal Revenue Service

Third, tax writers are likely to look closely at the S2.3 trillion associated with the exclusion of taxable income of 401K, IRA and other pension contributions. There will also be a focus in the Senate Finance Committee on revenues that can be raised by eliminating the exclusion of taxes on home sales, the exemption of municipal bond interest payments from federal taxes and the lower tax rates applied to dividends and capital gains.

Fourth, there eventually is going to have to be an agreement on repatriation of what the RSM Washington National Tax office estimates is the nearly 2.6 trillion in liquid assets held abroad. We still anticipate that this will not be part of the first round of tax cuts and more likely will be linked to potential infrastructure legislation in 2018 or 2019.

In our estimation, the serious debate will revolve around the nearly $1.3 trillion in tax expenditures on state and local tax deductions, the S900 billion in mortgage interest deductions, S800 billion in charitable giving and the $1.55 trillion in deferral of income from foreign corporations. That would provide S4.55 trillion in offsets for a S5.8 trillion tax cut, which would put it under the agreement in the Senate of a S1.5 trillion in additional debt added over the 10-year window. It would not, however, meet the revenue neutrality threshold that is the preference of the majority of the GOP House caucus.
Infrastructure: It’s likely a 2018 or 2019 event

The Trump administration has directly moved away from a framework organized around public–private experiments in financing infrastructure modernization. Instead, the administration is moving toward traditional federally sponsored financing using the Transportation Infrastructure Finance and Innovation Act (TIFIA) and the Rail Infrastructure Finance and Innovation Act (RIFIA), which are both subagencies inside the Department of Transportation. In our estimation, the Trump administration will attempt to increase funding via TIFIA and RIFIA to use them as de-facto infrastructure banks inside the federal government.

Based on our discussions with individuals on the relevant committees, the goal is funding about $200 billion that can be leveraged up to meet the $1 trillion funding goal of the administration. Given the significant damage in Texas, Florida, Puerto Rico and the Virgin Islands, there is going to need to be an additional source of funds to finance rebuilding. The price of any bipartisan supported legislation will likely revolve around lifting the national gasoline tax for the first time since 1993. Increasing the gasoline tax from 18.4 cents to 92 cents phased in over five years would bring in an additional $176 billion in the final year of the phase-in period, which would almost fully fund the seed capital for the infrastructure banks. While there is an opportunity to tie infrastructure modernization funding to the rebuilding and reconstruction following the three hurricanes, right now GOP is focused on tax reform, so infrastructure spending may be a late 2018 or 2019 priority.

Health care: Groundhog Day and why this is not going away

The second attempt at health reform died in the U.S. Senate recently. This does not mean that health care policy is dead, nor does it mean that attempts to repeal and replace the 2010 Affordable Care Act (ACA) have ceased. In the near term, the Congress and the administration will have to reauthorize the Children’s Health Insurance Program which provides care for children of low-income families and women’s pregnancy in many states as part of the fiscal year 2018 budget. In addition, should repeal and replace not happen in the near-term, there will need to be an increase in subsidies to large insurance companies to shore up the health care exchanges around the economy and states.

That being said, legislative writers in both chambers plan to put into fiscal year 2018 legislation instructions that permit the use of the fiscal year 2017 reconciliation rules in the upcoming fiscal year to fully repeal and replace 2010 ACA. Thus, the political imperative of repealing the ACA will not fade from the public debate and economic implications that come with regulatory oversight of roughly 20 percent of the U.S. economy.
TIGHT LABOR MARKET POSES INCREASING CHALLENGE FOR MIDDLE MARKET

Incentives can help, but companies need to offer what potential employees value

Joseph Brusuelas, Chief Economist, RSM US LLP

The number one staffing challenge that companies across industries are facing today is the lack of qualified workers available. The inability to find workers poses significant challenges, not only for businesses and policymakers, but for the broader economy. Moreover, if federal policy isn’t aligned with the tight labor market, bottlenecks in the economy due to a lack of supply that is already evident in agriculture, residential construction and manufacturing may spread to other areas of the economy, causing overall growth to slow.

Among the drivers behind this challenge, according to executives in the RSM US Middle Market Leadership Council (MMLC) survey, are competition for potential employees and simply finding people who want to work in their industry. Incentives that address the work environment, career development and compensation are attractive, and these are being offered by a plurality of middle market companies.

But age can have a profound impact on the way incentives are viewed. While most baby boomers and Gen Xers might see the inherent advantages of retirement plans and health care benefits, fewer than half of millennials place value in these incentives. Many incentives being offered by a majority of companies are important to this cohort; conversely, fewer organizations are offering the benefits with universal value.

Finding the balance

Workforce needs differ among industries, let alone specific companies. Given the importance of millennials in the workforce—by 2030, the cohort is anticipated to make up 75 percent of the labor market7—it’s expected to cater to that generation’s workplace preferences through their recruiting and retention initiatives. But millennials are not the only ones working or looking for work today. Boomers, with all of their experience and knowledge, are putting off retirement and working longer; Gen Xers are raising families and need to work as well. Companies need to identify which generation holds the talent they need and adjust their recruiting efforts accordingly.

Some offerings that companies should seriously consider are relatively easy and inexpensive to execute; others are more expensive and complex. To attract and retain a desired workforce in a tight labor market, however, management will need to strike a balance between the incentives they can afford to offer and those that potential employees value.

What companies are offering

In industries ranging from manufacturing to retail, healthcare to finance, what are companies offering to attract and retain qualified employees?

Health care benefits (offered by 90 percent of MMLC participants) and retirement programs (offered by 86 percent) are the foundational benefits that, depending on the company, will offer programs that may include options for cafeteria plans, wealth protection, health reimbursement and saving accounts, and the like. Perhaps not surprisingly, given the perspectives that younger adults often have on health and long-term issues, these benefits are among the least valuable to them when considering employment.

A majority of companies are offering opportunities to have input on how work is done (67 percent).

According to a recent survey of construction workers, “feeling in on things” was second only to “feeling appreciated for a job well done” as a priority for what workers look for in a job.1 Establishing a work environment where employees have opportunities to offer relevant input can go a long way toward making the employee feel valued—and want to stay.

It should not be surprising that compensation—hourly or annual, based on commission or performance—is among the top attractions offered by companies. Meanwhile, 58 percent of middle market executives anticipate increasing compensation levels and 56 percent say they plan to offer competitive incentive compensation arrangements in their efforts to recruit and retain labor, according to the survey. Total compensation considerations aside, it is worth remembering that compensation and benefits are not the primary attractions for employees—more often, it’s the quality of the job.2 And while a work-life balance may not be considered a high priority by boomers3, most millennials (84 percent) view it to be the most important factor in evaluating job prospects.4
Because acknowledgement by leadership of work done well is important to employees, recognition programs are offered by many companies (63 percent). A culture of recognition can be a relatively easy and low-cost effort that provides a high return on the investment in terms of work performance and employee retention.5

Other somewhat traditional offerings—one that appeals to employees who want a clear career trajectory—include internal and external training or education (offered by 56 percent). From apprenticeship programs to employers’ work arrangements with colleges and universities to individual professional development courses, companies understand that these programs are some of the most effective ways to identify, develop and retain the skilled workforce they need.

What companies should consider

Conclusions in studies of the behavior and values of different generations range widely, but, whatever the perspective, these studies make it clear that understanding what drives potential workforce talent is critical to attracting and retaining them. Many companies are missing opportunities to engage potential employees by focusing more on traditional incentives and less on what they value.

Contact

First, companies need to recognize and leverage the power of social media. Eighty-eight percent of millennials and nearly as many Gen Xers are on Facebook; a somewhat smaller but still sizeable percentage of boomers (62 percent) use the platform; three-quarters of Facebook users overall go to the site on a daily basis.6 Yet only 43 percent of middle market companies are using social media to attract employees. (Usage of LinkedIn, a more business-oriented platform, by all cohorts is significantly smaller than that of Facebook.) It takes an investment of time, effort, a budget and other resources, but can companies really afford not to be online when it comes to recruitment?

Work arrangements

Due to the unique nature of particular jobs, not every industry can offer flextime to employees; in this regard, agriculture, health care and manufacturing come to mind as location- and time-sensitive industries requiring most employees to be at a specific place and for a regulated period. But many industries and business cultures can tolerate employees working on various schedules. In these cases, as long as the work is completed on time, it may not matter what time of day it gets done or where. Recognizing this, more than half of middle market executives (56 percent) offer flexible hours or schedules. But the value of flexible arrangements across the generational board suggests more companies need to consider these work programs.

Given the relative popularity of flexible hours and schedules—not to mention the ubiquity of mobile technology—it is surprising that so few middle market companies offer work–from-home options (35 percent). While boomers in general may not want to work from home, this option becomes more popular with each successive generation.7 Businesses will have to consider how much actual face time they want, the technology they need and what policies to put in place for this option.

Career guidance

Members of every generation want to know the potential that employers hold for their professional futures. But less than half of middle market executives (43 percent) offer formal programs to help employees define career paths in their organizations. With half to two-thirds of Gen Xers and millennials expressing interest in being a boss or manager8, showing an employee a clear and realistic trajectory that holds the promise of a solid career should be considered for every company’s human resources toolset. Formalized mentoring programs (offered by only 21 percent) should be among those tools. If companies are finding that helping employees define their career paths is an effective means to retaining them, then providing guidance along the way can play an appropriate part of that effort.

Community

Social activities for employees are another relatively easy and low-cost incentive for any demographic. Yet with just over half of middle market executives engaging employees through social activities, this could be categorized as an underutilized approach. Not surprisingly, given its limited use to attract employees, social media is used to engage them by only one–third of middle market companies. Policies for volunteer days or other opportunities to give back to the community play into decisions by more than half of millennials to accept a job offer9, and three quarters or more of Gen Xers and boomers participate in such programs.10 Yet only about one–third of companies (34 percent) present company-sponsored opportunities to support community and charitable efforts.

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1 “Talent Development In the Construction Industry” (Sept. 28, 2015) FMI Corporation
3 Tolzis, A. “Generational differences in the workplace” (Aug. 16, 2008) Research and Training Center on Community Living, University of Minnesota
5 “The Employee Experience Index” (July 2017) IBM Smarter Workforce Institute and Globoforce's WorkHuman® Research Institute
7 “Why baby boomers don’t like to work from home” (Feb. 3, 2013) MarketWatch
8 Fottrell, Q. “What Men, Women Value in a Job” (Dec. 11, 2013) Pew Research Center
9 Scott, R. “Millennials Rule at Giving Back” (Jan. 18, 2015) Forbes
10 “Rewarding a Multigenerational Workforce” (September 2008) WorldatWork
11 Mitchell, A. “The Rise of the Millennial Workforce” wired.com
The real economy sent a message in the third quarter: We are losing confidence and may begin pulling back on plans to hire, raise compensation and increase capital expenditures due to the lack of progress on substantial policy reform (see charts and questions, page 17).

The topline RSM US Middle Market Business Index (MMBI) eased to 125.7 in the third quarter from 132.1 in the prior quarter, erasing much of the bump in middle market business optimism that followed the 2016 presidential election.

While the outlook remains strong, the decline does imply that improvement in the overall index during the past year is likely the result of both stronger economic fundamentals and the recovery from the 2015–16 earnings recession that predated the 2016 election. Thus, we think that a return to levels closer to the fourth quarter of 2016 (120.1) in the near-term isn’t out of the question amid modest growth expectations and a tight labor market that is increasingly creating challenges for middle market businesses.

It is important to note that the survey was completed prior to hurricanes Harvey and Irma. Given the hit to the petrochemical industry, the fourth quarter topline estimate will likely reflect a slowing of overall manufacturing conditions and higher energy prices during the survey period.

The details of the survey on expectations point to modest future gains for the overall economy, hiring, compensation and outlays on capital expenditures. A plurality of middle market executives indicated that the economy improved somewhat or substantially in the current survey, down from a majority in the previous quarter. This matches up well with

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**Source:** RSM US LLP
what will likely be an expansion of nearly 3 percent in U.S. GDP in the second quarter versus what is shaping up to be a more modest expansion closer to 2 percent in the current quarter. A majority continue to forecast an improving economy during the next six months even after the loss in the aforementioned topline business optimism.

Expectations of a better economic environment are likely tied to the improvement in the outlook on net earnings. A total of 49 percent of middle market executives indicated that net earnings improved somewhat or substantially in the current quarter, down slightly from 53 percent previously. However, during the next six months, 61 percent said they expect noticeable improvement in net earnings versus 67 percent in the second quarter of the year. Even though actual performance and outlook on net earnings have decreased, we have seen a sustained increase over the past three quarters compared to last year.

On the gross revenues front, middle market executives indicated that the outlook remains positive with 54 percent noting an improvement compared with 55 percent previously, while the forward-looking six months set of questions elicited a response that suggests 65 percent of middle market executives anticipate an improved outlook versus 67 percent previously. The declines, though modest, may be linked to fading hopes for significant corporate tax reform and is an aspect of the MMLC survey report worth monitoring in future surveys.

The combination of an upgraded economic outlook and sustained improvement in net earnings should partially offset any loss in plans to expand linked to the lack of tax reform and infrastructure spending this year. That said, we are now somewhat concerned about the direction of hiring and compensation among middle market firms.

According to the survey, 43 percent of middle market executives reported an improvement in hiring conditions, down from 47 percent last quarter. Moreover, only 44 percent of those surveyed indicated that they expect conditions to improve six months ahead. The survey also indicated a decline in overall capital expenditures, with only 40 percent reporting improvement and less than half (46 percent) stating that they intend to increase outlays on software, equipment and intellectual capital six months ahead.

Lastly, data on pricing, inventories and borrowing showed continued stability.

In the special question portion of the survey, middle market executives indicate significant problems with a tightening labor market and the need to use oversized compensation to make hires. A stunning 72 percent reported that they were having some or substantial trouble finding qualified personnel for open positions. As a result, 64 percent indicated that they turned to higher compensation levels to attract labor. With respect to unskilled labor, 42 percent stated they had trouble filling such positions and 52 percent said they turned to offering higher compensation to obtain such labor. One big risk to the outlook for the middle market and the real economy going forward is thinner profit margins as compensation takes up a larger portion of the balance sheet.

On a more encouraging note, middle market executives responded strongly to questions on the impact of potential infrastructure spending. A super-majority stated that they saw potential business opportunities through bidding on projects related to the national energy grid, telecommunications networks, telecommunications network security, interstate highways and local roads or highways.