INVESTMENT INSIGHTS

Inflation Reduction Act of 2022

Key Elements and Implications on Financial Markets

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30+ year veteran of the financial industry, known for unique ability to translate policies coming out of Washington D.C., into growth strategies for financial advisors and high net worth investors.

On August 16, 2022, President Joe Biden signed the Inflation Reduction Act (P.L. 117-169) of 2022 into law. Though it is being referred to as "IRA" out of convenience, it should not be confused with the retirement account of the same acronym. The IRA bill's nickname, however, is not nearly as important as the content of the law — it is the final iteration of the Democrats' failed $3.5 trillion Build Back Better effort that they embarked on shortly after winning control of the White House, House of Representatives, and a simple majority in the Senate in the 2020 elections. Let's break down the key elements of the bill and its implications for corporations and financial markets.

The Revenue Elements

Minimum 15% Corporate Tax on Book Profits

Among several revenue elements of the IRA, the biggest is a new corporate minimum tax on the book profits of large corporations. Corporations compute book profits reported to shareholders using a different calculation method than is used to calculate income for tax purposes. In essence, the book profit tax is an alternative minimum tax (AMT) on corporations earning more than $1B annually of adjusted financial statement income for the past three years on a rolling basis.

Senator Kyrsten Sinema (D-AZ) won a carve-out to allow book income to be reduced by accelerated depreciation as computed for tax purposes rather than the slower depreciation method used for book purposes. This change prevented capital-intensive businesses from being unfairly singled out by the new book income minimum tax. However, corporations have various methods for calculating book profits. Conceivably, similarly situated corporations could be treated differently for the book income tax purposes. Corporations that alter their book income to reduce tax liability could report misleading information to shareholders, potentially politicizing the Financial Accounting Standards Board (FASB) rules governing this calculation.

The book profit minimum tax introduces additional complexity to an already overly complex tax code. It also undermines the tax code's specific deductions and credits that Congress added to spur corporate actions. A credit adds value to an investment that Congress wants to support. If a corporation cannot use the credit because they are subject to the 15% minimum book profit tax, it negates the tax credit incentive.

Investors must be nimble; this process will be introduced in tax year 2023, so corporations and the market must quickly adjust to this new tax regime. It is imperative to work closely with your financial advisor to gauge the effect and impact of this tax code change on your portfolio's stock valuations.

1% Stock Buyback Tax

The IRA imposes a 1% tax on corporate stock buybacks. While this provision provoked a storm in the financial press, projections anticipate a nominal net impact. And though the new tax may influence a handful of corporations' decisions to buy back stock or not, most corporations do not believe it will substantially affect their cost-benefit analysis. Had this tax been enforced over the last year, revenue estimates would have been $8.4B in taxes from the approximate $1T in buybacks.

Additionally, the new tax arguably imposes a double tax on redeeming corporations because corporations redeem shares using previously taxed profits on which they will have to pay the 1% tax starting in 2023.

Limitations on Excess Profits

The IRA includes a two-year extension through 2028 of the limits on an individual's ability to deduct business losses. Under this rule, an individual taxpayer's deduction for business losses cannot offset more than $270k of income from other sources ($540k for joint taxpayers). Taxpayers with disallowed losses may carry those losses forward to the next succeeding taxable year.

Prescription Drug Pricing Reforms

Democrats have long sought to reduce the price Americans pay for prescription drugs. While the IRA addresses this concern, it only applies to Medicare beneficiaries and does not address non-Medicare prescription purchases. The IRA limits the amount Medicare beneficiaries pay annually for medications to $2000 and limits monthly insulin payments to $35.

Starting in 2026, a subset of the drugs most commonly prescribed for Medicare beneficiaries are subject to negotiation, beginning with ten drugs and increasing over time. Pharmaceutical companies are exposed to a rebate rule if their drug prices rise faster than inflation. The budget scoring of the IRA considers these Medicare savings and rebates as additional Federal revenue.

Some industry experts have expressed concerns that the natural consequence of lost profits on Medicare sales will be reduced investment within the pharmaceutical industry for research and development of new drugs. The change in revenue streams could impact the long-term valuations of these companies.

Closing the Tax Gap

The IRA appropriates significant new funds to the IRS to close the tax gap (the difference between the amount the IRS collects and the total amount of legitimately owed taxes). Because the taxes go uncollected, it is unknown precisely how big the gap is, but estimates put it somewhere between $500B and $1T annually. The gap is a significant factor in the annual Federal budget deficit. This year, the Federal government expects to bring in just under $4.5T, so $500B represents 11% of the projected revenue.

With the increased budget, reports say that the IRS expects to hire 87k new employees, a break from historical, insufficient hiring stemming from long-term underfunding. As a result, about 50% of the IRS's employees will now be eligible to retire within the next five years. Looking ahead, the Service anticipates new employee placement in customer service, tax processing, and enforcement roles, as well as much overdue updates to antiquated computing systems.

As the law does not stipulate an income limit, President Biden and Treasury Secretary Janet Yellen promise that these new enforcement agents (auditors) will only focus on individuals and families earning over $400k. Taxpayers above these income thresholds should anticipate an increase in their chance of being audited as the Service hires and trains new auditors over the next few years. The Service aims to return the audit rate closer to the historical norm of 1% per year for these higher-income families. The IRS hopes that a large part of the anticipated additional revenue will come from "voluntary compliance" resulting from individuals reporting more tax out of a greater fear of being audited.

The Expenditure Elements

Climate Change Mitigation

The largest expenditure category within the IRA addresses climate change mitigation with approximately $369B allocated toward that effort. The IRA adopts an "all of the above" strategy for energy production. While the legislation primarily focuses on renewable energy sources like solar, wind, and clean energy storage, it accepts the need for a transition period supported by natural gas and nuclear energy. Proponents believe that, by 2030, the IRA will reduce carbon emissions in the U.S. by 40% over 2005 levels.

Industries need sizable technological advances and significant infrastructure overhauls to meet these carbon reduction goals, so this is an area in which the bipartisan infrastructure bill that Congress passed earlier this year works in tandem with the IRA, each representing a sizable investment opportunity. Long-term investors should consider investment opportunities that benefit from both the infrastructure and climate change mitigation bills, such as the electrical grid, energy storage, battery technologies, water, and the like.

The IRA also provides tax credits to households for adding renewables at home and purchasing electric vehicles (E.V.). The full E.V. credit of $7,500 on cars and trucks has income limits, purchase-price limits, and domestic manufacturing requirements. Used cars are also eligible for a tax credit for the first time, either the lesser of $4,000 or 30% of the car's value.

For vehicles to qualify for a tax credit, the MSRP cannot exceed $55k for cars, $80k for SUVs, vans, and trucks, or $25k for used vehicles. Additionally, the final assembly for new vehicles must occur in North America. Single filers with a modified adjusted gross income under $150k, joint filers under $300k, and head of household filers under $225k are all eligible for the E.V. credits.

Drought Resiliency

States in the western and southern regions of the United States are experiencing unprecedented droughts. Hailing from Arizona where water rights are a huge concern, Senator Sinema successfully added $4B to address water issues to the IRA.

Enhanced Affordable Care Act Subsidies

The IRA extended subsidies from the CARES Act through 2024 that temporarily increase the premium subsidies lower-income Americans receive to offset the cost of their health insurance premiums, as the COVID-19 virus continues to stick around, likely for the long term.

Deficit Reduction

Senator Joe Manchin (D-WV) required that any revenue raised by the IRA be split as equally as possible between deficit reduction and expenditures. Per his demand, the IRA applies $300B toward deficit reduction over the next ten years, though the Congressional Budget Office projects that the U.S. will add $16T of debt over the next decade.

While there is some discussion as to how much or if the bill will reduce inflation, the general consensus is that the bill will make a dent in the deficit and serves as a starting point for a lot of issues impacting Americans, ranging from climate change to prescription drug costs and beyond. With the benefits and implications of the Inflation Reduction Act of 2022 being so far-reaching, the financial markets will likely be impacted in one way or another, so it is essential for investors to work with financial advisors to ensure portfolios are built for resiliency. For further information on the IRA bill from the White House, please click here.

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