HOW WILL TAX REFORM IMPACT THE ECONOMY?

Global Financial Private Capital

SYNOPSIS

- Republican leaders released a plan this week to overhaul the U.S. tax code, which proposes reduced tax rates for businesses and select individuals.
- The short-term implications of the tax plan appear to be positive, while the longer-term impact is more of a mixed bag.
- One of the most dangerous financial decisions an investor can make is betting on the outcome of a government decision.

TAX OVERHAUL

Republican leaders released a plan this week to overhaul the U.S. tax code, which proposes reduced tax rates for businesses and select individuals. Their goal is to get these changes through Congress by the end of the year, so their efforts will most likely grab headlines over the coming months.

The size of the plan is ambitious, but there are three components in particular worth discussing. The first is the handling of foreign earnings, which could provide a quick boost to the economy. The other two are the changes to the corporate and personal tax code. These are longer term in nature, making any analysis more difficult to quantify.

Let's first discuss the details of each and how they could potentially impact the economy, and then we can assess the probability of any of it actually happening.

FOREIGN EARNINGS

The new proposal calls for a one-time reduced tax rate on foreign earnings in overseas bank accounts. This change addresses one of the biggest issues facing multinational corporations who have refused to repatriate their cash back to the U.S.

Consider a U.S. based clothing store that decides to expand to Paris. They sell a bunch of clothes over the course of a year, and the cash they earned gets placed into a bank account in France.

If the company wanted to move this cash from their French bank account to the one back home, they would need to convert the Euros into U.S. dollars and then transfer the funds to their "onshore" bank account. This process is referred to as "repatriation."

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Congress's Joint Committee on Taxation estimates that as of the end of 2016, U.S. companies held an astronomical $2.6 trillion in cash overseas. The primary reason is because management teams refuse to pay the 35% tax rate applied to repatriated cash.

If the Republicans were to convince companies to bring back even a portion of this cash, it could benefit our economy and long-term investors in three ways:

1. **Reinvest**: Companies could reinvest back into their business via research and development, buying competitors, hiring new employees, and raising salaries.
2. **Special Dividend**: Management could pay a special dividend and return the cash to shareholders, which could be a windfall in many circumstances.
3. **Share Buybacks**: The cash could be used to buy back company stock. By lowering the share count, the stock price could rise over time and increase shareholder wealth.

Some uses of cash would benefit the economy and shareholders faster than others. Paying dividends or buying back shares would be immediate whereas reinvesting back into the businesses may take several years to pay off. I would expect to see companies employ a mix of these options to not only reward current shareholders but to attract new ones as well.

For example, a pharmaceutical company could use half of its repatriated cash to fund research into new lifesaving drugs and pay its scientists more money, and then use the other half to pay its shareholders a one-time 10% special dividend.

Ironically, the government would likely be one of the biggest beneficiaries because they could potentially collect hundreds of billions in additional tax revenues from:

- **Repatriation**: The government will not drop the tax rate to zero, so they can collect taxes on the repatriation back to the U.S.
- **Dividends**: Any special dividends or increases to existing dividends are taxed when paid to investors.
- **Consumer Spending**: The increase in consumer wealth from pay raises and rising share prices would most likely translate to more spending, where the government would collect even more revenue from consumption taxes such as the sales tax.

Let's use some math to highlight just how much the government could gain in additional tax revenues if they were to lower the tax to 10% next year. If that convinced companies to repatriate $1.25 trillion, or approximately 50% of the total amount sitting overseas based on Congress's estimates, the federal government would collect $125 billion to start.

That leaves $1.125 billion ($1.25 – $0.125 = $1.125) for companies to put to work. If they paid out 25% to shareholders via a special dividend at an average tax rate of 17%, then Uncle Sam would get an additional $48 billion ($1.125 x 0.25 x 0.17 = $48).

The additional taxes from consumer spending are too difficult to estimate, but even if we were to assume that they were zero, the government would still take home $173 billion ($125 + $48 = $173) in 2017 from just two forms of taxation.

The U.S. Treasury Department estimates that tax revenues for 2017 will be $3.6 trillion, so the added benefit from this hypothetical scenario would be 4.8% ($173/$3600 x 100 = 4.8%) for doing practically no work.

More importantly, the benefit to the economy and to the government would be felt quickly. These companies do not want to sit in cash for the same reason retirees are frustrated with cash investments. They earn nothing in today's interest rate environment, so this proposal could act like an adrenaline shot for the economy next year as management teams swiftly deploy this cash.

CORPORATE TAX OVERHAUL

The headline feature of the proposed tax overhaul is lowering the corporate tax rate from the highest in the developed world at 35% down to 20%. However, three more granular changes to the existing corporate tax code are worth discussing.

The first is the ability for businesses to immediately deduct capital investments, except for buildings, instead of depreciating them over time. The goal is to spur spending on new machines and the workers hired to operate them.

For example, if a manufacturing company purchases a new machine today for $10 million, it must depreciate the cost of the machine over a specified number of years, which is usually the time period that management expects to use it or a set period from the Internal Revenue Service (IRS).

Meaning, if the company earned $50 million in revenue this year, and management expected to use the machine for 10 years, they could only deduct $1 million ($10 million/10 years = $1 million).

Allowing the company to deduct the entire cost of the machine would reduce the tax basis by the full $10 million this year, which saves the company taxes paid on $9 million in revenue ($10 million - $1 million = $9 million).

If the company paid a 35% tax rate, this would equate to a savings of $3.15 million ($9 million x 35% = $3.15 million), or 6.3% of the total revenue earned that year. Lower taxes and less confusing accounting rules are two strong incentives for management teams to spend more money to grow their businesses.

The second feature is the proposed limit on the ability of corporations to deduct interest payments on debt. Currently, companies can deduct most interest paid on debt in the same manner that home owners can deduct interest paid on the first $1 million of a mortgage.

This tax advantage often makes selling corporate bonds more attractive than other forms of raising capital. Removing this deduction will likely have a profound impact on financial decisions ranging from large purchases to mergers and acquisitions.

The third feature is the proposed cap at 25% on taxes paid by companies that are not currently subjected to the corporate tax rate. These tend to be smaller companies like family businesses or sole practitioners who pay their taxes through the individual returns of their owners.

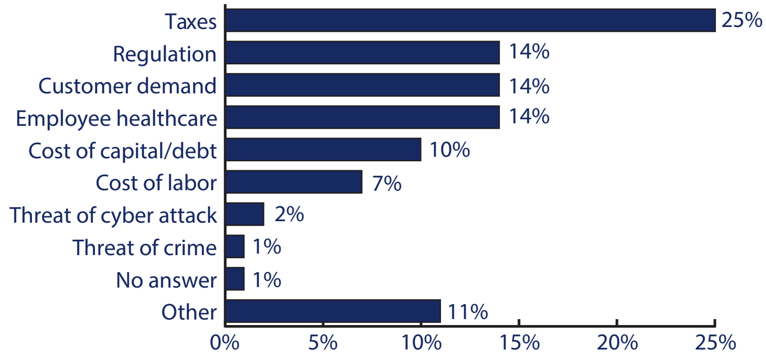
Combine this cap with the proposed 20% tax rate for corporations, and it could be a game-changer for two reasons:

1. **Size of Small Business**: The U.S. Census Bureau reported in 2014 that firms with fewer than 500 workers accounted for 99.7% of businesses in the U.S., and firms with less than 20 workers made up 89.4%.
2. **Job Creation**: According to the U.S. Small Business Association, small businesses accounted for 63.3% of net new jobs from the third quarter of 1992 until the third quarter of 2013.

Said another way, smaller businesses drive much of the U.S. economy via employment, and the survey in the next column shows why these proposed changes matter so much to them.

Any initiative that incentivizes small business owners to expand, hire more employees, and/or pay existing personnel more money should ultimately lead to additional economic growth. Lowering their tax

WHAT IS THE MOST CRITICAL ISSUE CURRENTLY FACING YOUR BUSINESS?



Source: CNBC/SurveyMonkey Small Business Survey, Q2 2017

burden is clearly one of the quickest and most effective ways to create a runway for economic growth.

PERSONAL TAX OVERHAUL

The potential impact from changes to the personal tax code on the economy is less clear. For example, the plan calls for increasing the child tax credit, but no details were given around the actual amount.

That being said, the biggest change announced involves reducing the number of individual tax brackets from seven today down to three or four. These would be set at 12%, 25% and 35%, with the option of a fourth higher rate on the highest-income households.

Moving to fewer tax brackets means different things for different levels of earners, so it's tough to say that this is a net benefit or cost to the country. The real impact will be determined when we get more clarity into the impact on high income earners, since the top 10% earners account for 70% of all income tax revenue[1].

Even though details are sparse, there are two proposals worth highlighting. The first is ending the state and local tax deduction for individuals. Currently, any income tax paid on the state level can be deducted from a federal tax liability. Removing this deduction means that citizens living in high-tax regimes will end up paying a lot more in tax relative to today.
The second is doubling the basic standard deduction to $12,000 for individuals and $24,000 for married couples.

Doing so would practically eliminate the mortgage interest deduction because a taxpayer would have to have at least $24,000 in mortgage interest and charitable deductions before receiving any benefit from itemizing.

IMPLICATIONS FOR INVESTORS

The short-term implications of the tax plan appear to be positive, while the longer-term impact is more of a mixed bag. Only time will tell as we continue to get more details on the specific aspects of this ambitious proposal.

The next step is to determine the odds of any of this actually happening by the end of 2017. Our government is notorious for presenting grandiose plans that die on the vine, and unfortunately, I expect this tax plan to follow suit for three reasons.

The first is the time it takes for policy to become implemented. The checks and balances in our government combined with the self-interested behavior of politicians makes big changes move at a snail's pace.

Think back to 2009, when the Obama administration was in the White House and Democrats controlled Congress. Despite what appeared to be a clear path to healthcare policy, it still took over six years for Obamacare plans to be made available to Americans.

The second is how the final bill will compare to the current version. Any major overhaul to the U.S. tax code will most certainly face opposition from politicians on both sides of the fence. Two lightning rods will likely be the interest deduction for corporations and ending the state and local tax deduction for individuals.

For example, imagine how politicians from states with high income taxes will vote knowing that their constituents will no longer be able to deduct the income tax paid to their home state from their federal taxes. Furthermore, several high tax regime states like California and New York carry a lot of weight in presidential elections due to the number of electoral votes they control. These factors will likely weigh on the minds and votes from politicians.

The third is the complexity of the U.S. tax code. The number of deductions and exceptions to existing rules have turned the tax code into a Jenga puzzle, where politicians are too afraid to pull a piece for fear of making it all crash down. The last time a major overhaul of the U.S. tax code occurred in 1986, and it will take a lot of effort in the coming months to see this bill or any other get through Congress.

Therefore, all we can do for the time being is analyze the potential impact of policy changes, but that's where it ends. One of the most dangerous financial decisions an investor can make is betting on the outcome of a government decision, so we are just going to have to be patient and wait to see if this bill or a modified version ever gets passed.

The bottom line is that the proposed tax overhaul would most likely benefit the economy, but it is far too early to modify an investment strategy to benefit from any anticipated tax policy changes.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer,
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[1]*Source: Capital Economics*