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MARKET INSIGHTS

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from the Connected Wealth team

Implications of a Changing U.S. Tax Code

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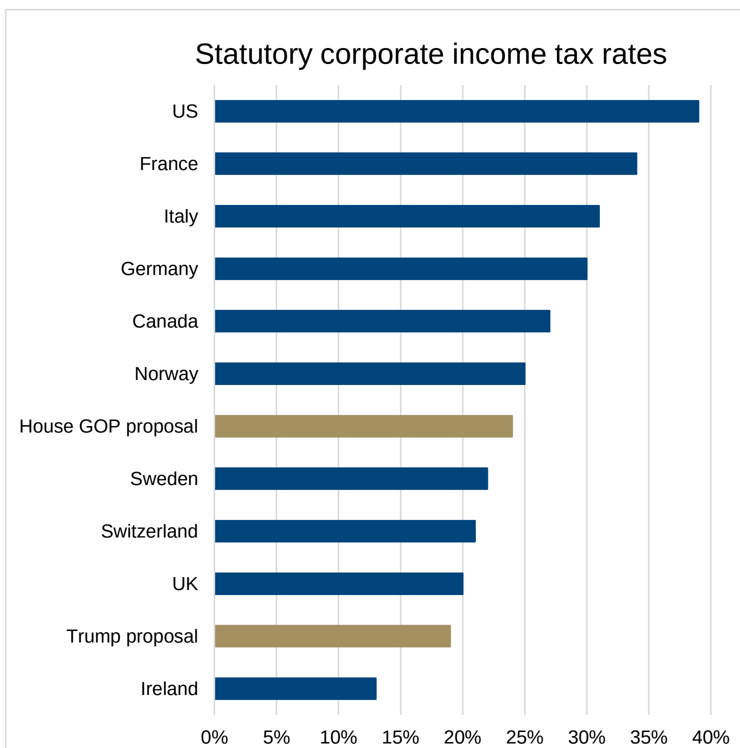
Since the surprise results of the November 8th U.S. election, one of the most widely publicized topics has been tax reform. President elect Donald Trump was very vocal during his campaign, saying that he wanted to drastically overhaul the current tax regime. However, the U.S. is a democracy, not a dictatorship, so the President will have to work with House GOP on pushing through changes. There are clear differences in what the House GOP and what Donald Trump are proposing. Until both constituencies work together to iron out the details, uncertainty will remain. What we do know is that, at the forefront, both want to lower the corporate tax rate from 35% to something comparable with other developed nations which, at present, is the highest among developed nations. There are also proposals by both to change the treatment of capital expenditures and of interest expenses. It is also likely that there will be an incentive to repatriate foreign profits at a reduced tax rate or a onetime tax holiday.



Lowering the statutory corporate tax rate will be most beneficial for companies with the highest effective tax rates. This millennium, energy firms have paid the highest tax rates while Health Care and Technology firms have paid the lowest.

There is a difference between the statutory tax rate (the combined federal and local state tax rates) and the effective rate, which is the rate corporations actually pay. This is because of tax breaks such as depreciating fixed assets and interest deductibility. Although the statutory rate in the U.S. is 39%, the effective rate is actually just 28%.

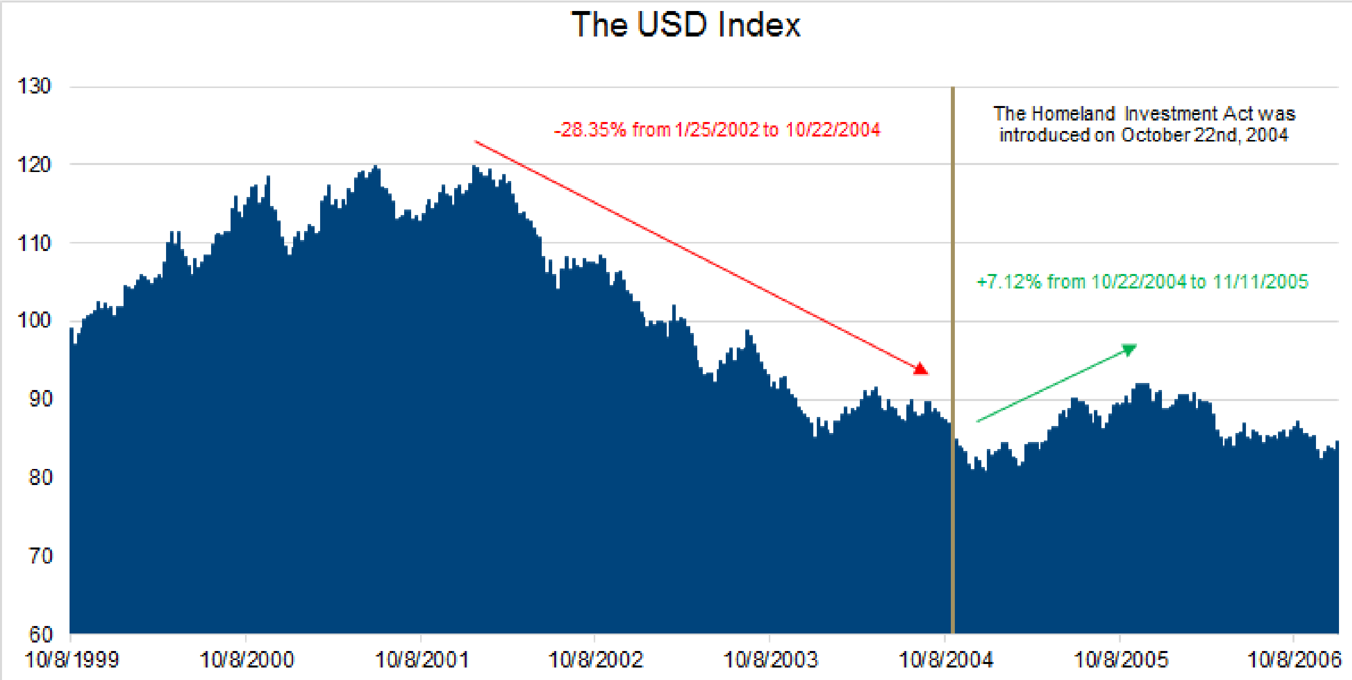
One of the ancillary intentions of the reforms is to get the effective rate closer to the statutory rate. This would mute part of the reduction in the headline rate, however, corporate finance departments are likely to adopt new strategies to maximize value under a new regime. Goldman Sachs estimates that each percentage point decline in effective U.S. corporate taxes will result in roughly $1.50 in 2017 S&P 500 earnings. Last year, the S&P 500 had $107 EPS. As such, a 10% reduction in the effective tax rate would equate to roughly $15 in earnings. Using the forward P/E ratio of 17x would represent a 255 point lift for the S&P 500, which currently sits at 2,278. The House GOP is proposing a 15% reduction and Trump is pushing for a 20% reduction. Although hard to say how much of the recent rally is attributable to proposed tax reductions, markets rarely wait for the pen to hit paper.

A key difference between the GOP and Trump's tax agendas is the treatment of capital expenditures and interest expenses. This will have a meaningful impact on a plethora of companies that have built businesses around the current tax treatment of both CapEx and interest expense. The House GOP plan is to allow companies to immediately, fully deduct the cost of new domestic capital investments and to no longer allow them to deduct net interest expense. Trump wants to allow manufacturers the option of either fully deducting new domestic capital expenditures or net interest expense.

Currently, capital investments depreciate over time and interest expense is fully deductible. This may sound like accounting minutiae, but it can have a profound impact on how companies use and deploy capital. Hypothetically, both proposals should incentivize manufacturers to invest in domestic capital assets (plants and equipment), helping make America great again. This investment would reduce taxable profits drastically in the year the investment is made, and thus lower the current year tax bill.

This might be easier to understand with a real world example. This week, Ford CEO Mark Fields held a news conference and stated that they have pivoted their corporate strategy to expand operations in Mexico and have decided to make a $700mm expansion to their Flat Rock Michigan manufacturing plant. If this investment is made after the proposed tax changes take effect, their profits this year will be reduced by $700mm. Because they have an effective tax rate of 28% (as of 12/31/2015), this could save them ~$196mm in taxes this year. This perk is only applicable for U.S. investment, which essentially would make this plant cost ~$500mm if built in the U.S. and $700mm if built in Mexico.

Currently, U.S. corporations that have foreign operations pay no domestic tax on profits earned internationally. Both constituencies want to put an end to this. But they also don't want to crush companies that have massive cash hoards overseas, making it likely that there could be some kind of a tax holiday, similar to what George Bush introduced in the fall of 2004. If this were to happen then it would have a profound impact on foreign exchange rates and companies with foreign operations. The impact on the U.S. dollar was obvious following the last repatriation tax holiday. Fundamentally, this is because U.S. corporations will be selling foreign currency to purchase U.S dollars; reducing the supply of dollars and increasing demand. Currently, there are $2.4 trillion in overseas profits, much of which have been reinvested. Even so, there is still roughly $1 trillion sitting in cash. Investors typically do not like useable cash on balance sheets. CFOs, who know this, will be left with two options: invest the capital or give it back to shareholders in the form of dividends and buybacks. After the 2004 holiday, many multi-nationals used some of the repatriated cash to buy back stock, buybacks in 2004 rose by 84% versus the year before, according to Goldman Sachs. A similar effect would be a boon for stockholders. It won't all go to buybacks though. We believe much of it will be invested, giving a major tailwind to industrial and technology companies that will be responsible for creating the new plants and equipment.



Until the pen hits the paper and a new tax code is enacted, much of the implications are left to speculation. But with the similarities in the agendas that have been articulated by both the House GOP and Donald Trump, we were able to outline some of the likely scenarios and possible ramifications. We do know that any change will have an impact on all of the stocks we own because, as Benjamin Franklin eloquently wrote in 1789, “in this world nothing can be said to be certain, except death and taxes.”

Charts are sourced to Bloomberg unless otherwise noted.