The Investment Letter

Volume 88, No. 12 December 2017

Can Tax Reform Extend the Bull Market?

Tax reform and what it could mean for your investments

Tax reform is never the scintillating topic of best-sellers, and it's difficult to find good, solid summaries of tax reform efforts that haven't been distilled and politicized to the point of uselessness. What's more, with so many moving pieces (as of December 1, 2017 the Senate bill has yet to pass), and so much left to decide (the two versions still need to be reconciled), the speculation and analysis around current and final tax code changes in each version keep changing, almost with every new internet search on the topic. For our December 2017 newsletter, we take a step back, isolate the core tax code changes most meaningful to investors, examine the changes they may bring to your investments, and consider whether these changes may just extend the current bull market.

What is the status of the tax bills right now?

In mid-November, the House passed its tax bill, creatively named the Tax Cut and Jobs Act. Even without support from 13 Republicans and all the Democrats, the bill passed just two weeks after it was first introduced.

With the Senate bill still in draft form, the Senate returned from Thanksgiving to work on their tax reform effort.

Once the Senate version passes, leaders must still reconcile the differences between the two bills, and finalize the changes that the tax code will ultimately reflect.

Corporate Taxes – Rates and Repatriation of Earnings

The House's *Tax Cut and Jobs Act*, and the Senate's current equivalent, both permanently lower corporate taxes, from 35% to 20% – in an effort to make the US more competitive and alleviate pressure on companies to move their earnings, and their operations, overseas. It's also worth noting that this cut represents the biggest one-time, business tax cut ever.

But, there's also much more for shareholders to get excited about.

Repatriation of Earnings

Under both tax bills, companies will be able to repatriate money from low-tax havens like Ireland at a reduced rate. Instead of repatriating that income at the current 35% rate, companies now may be able to send those funds back to the United States at reduced rates, currently set at 14% (House) or 10% (Senate) for cash and cash equivalents, depending on which version of the tax bill ultimately prevails.

There's also the sea-change shift in corporate tax philosophy where companies may now primarily pay taxes in the countries where earnings are booked, instead of also paying the US Treasury the difference between that foreign country's tax rate and our domestic 35% rate.

How will increased corporate gains, and freer flow of funds, affect your investments?

The big question here is: What will companies do with the funds made available from this historic tax cut? Bloomberg reported on November 29 that many companies, among them Fortune 100 like Coca-Cola, Pfizer, and Cisco, have indicated

Investment Counsel Inc.

Established *1929*

5225 East Cook Rd • Grand Blanc, MI 48439 • (800) 689-7897 • www.Invest-Counsel.com

that they will use gains from proposed tax cuts to increase dividends, buy back shares, or pay down debt. With higher dividend payouts, healthier balance sheets, and higher EPS metrics, we would anticipate higher valuations of shares, and ultimately, advancing share prices.

There's also an indirect benefit to investors when more revenues survive into after-tax calculations. Corporate tax gains realized through these tax cuts will also find their way into reinvestment into corporate operations, assets, and personnel. When funds flow more freely within a company's global operations, corporate decision-makers are provided with a wider variety of investments to pursue, and with the ability to invest business income into the projects that provide the highest returns, with less encumbrance from tax considerations. Better reinvestment of funds into company infrastructure, operations, and personnel may also lead to bolstered share prices. The opportunity to invest in new plant and equipment has the opportunity have a long-term positive impact on earnings.

Capital Gains and Dividends

The House bill, and the most current version of the Senate bill, do not directly change how investment income is taxed, leaving in place a system where taxation is calculated based on how long an asset has been held, and how much money the individual holding it has earned. It's this last provision where the indirect change to taxes on capital gains and dividends comes into play. While long-term capital gains taxes remain constant, new income tax brackets and/or rates (more to follow on this, below) do change the underlying tax bracket that is used to calculate taxes for short-term gains and dividends.

Consider: Hold an asset for more than one year, and you'll pay no taxes if you make less than $37,950 annually. The rate climbs to 15% if you make more than that, but less than $418,400. Make more than $418,400 and you currently pay a 20% long-term capital gains tax on assets held longer than one year. None of that is slated to change.

Currently, and under the new plans, assets sold within a year of acquisition will continue to be taxed at ordinary tax rates, which will change, according to the new tax brackets. Dividends will also be taxed at these new ordinary tax rates. Also, the additional 3.8% tax on capital gains and dividends (targeted at taxpayers earning more than $200,000 annually) is not expected to change at all.

So, while the framework driving the calculation of capital gains taxes remains the same, some of the numbers factored into that calculation will change.

Dividends, on the Corporate Side

Double Taxation on corporate profits, long maligned as one of the most unjust provisions of current tax code, may one day go away if changes currently in debate for the Senate tax bill survive into law. The final Senate Bill may contain a provision that includes a dividends-paid deduction, which effectively would reduce or eliminate the current system where corporate profits are taxed at both the entity and shareholder levels. Currently, the Senate draft sets the dividends-paid deduction at 0%, but the bill does provide the framework and reporting to accommodate the addition of a real deduction in the future. If the deduction does, one day, go into effect, the result could be a push for more income to be distributed in the form of higher dividends to shareholders.

Changes to Taxes on Capital Gains and Dividends, and what it means to you

Changes to taxes on capital gains remain minimal in this current tax reform effort, with the small caveat that short-term gains may be taxed at different rates, should your tax bracket change. Dividends, likewise, will continue to be taxed, using a similar methodology, if at a slightly adjusted rate. The big change here is the idea that dividends may one day no longer be taxed as heavily at the corporate level, which, along with effects rolling down from the overall corporate tax rate cut detailed above, could mean larger dividend payouts to investors in the not-so-distant future.

Some Detail on the Proposed Changes to Taxpayer Tax Brackets

The House Bill cuts the number of tax brackets from seven to four (12%, 25%, 35%, and 39.6%), while the Senate draft, on the other hand, keeps the current number of tax brackets at seven, but lowers most of the marginal rates.

AMT

The long-reviled Alternative Minimum Tax (AMT) gets revoked both under the house plan and the draft senate plan.

What do changes to AMT and Taxpayer Tax Brackets mean to you?

While not directly tied to corporations, or your investments, changes to taxpayer tax brackets will change the rates at which some of your investment income is taxed. The repeal of the AMT, likewise, will also change this calculation and the complexity of your taxes.

Conclusion

Of course, it remains to be seen whether this current tax reform effort extends our current bull market or if it will achieve goals like inducing sustained economic growth, simplifying the tax code or making the US more competitive with other countries competing for the same pool of corporate operations, pocketbooks, and jobs. However, from the perspective of an investor following these efforts and the proposed changes, a freer flow of funds across a company's global operations allows for investment monies to be invested more freely, providing a wider range of higher-return investment prospects to pursue. These potentially higher investment results, coupled with more revenues surviving into after-tax calculations enables earnings to increase, and so too, hopefully, share prices may follow suit.

Revisions to tax brackets, and the repel of the AMT, should lead to lower taxes for most taxpayers, which too may lead to greater investments into equities and bolstered share prices.

At this early date, however, much remains to be accomplished. The Senate bill must be finalized. Republican leaders must reconcile the differences between the two versions, and they must deliver a single, unified version for Presidential signature. Key differences do remain, however, like one such provision, being contemplated in the Senate's current draft, which would introduce a First-In-First-Out (FIFO) rule when selling stock, meaning that investors would be forced to sell their oldest shares first. This would remove a current tax tool that has allowed investors to control the way they recognize their gains as stock prices appreciate over time.

As of this writing, the bull market remains strong – crossing past the 24,000 level for the first time ever. Yet, however much has been accomplished, much remains to be done, decided, and implemented. ■

Investment Counsel News

Everyone at Investment Counsel wishes you and your family a happy, healthy and joyous holiday season and a very prosperous 2018!