A Cash Windfall

by Craig D. Hafer, President

The irony was not lost on many in the news media. As the president signed the Tax and Jobs Act of 2017, which amounted to providing one of the largest corporate tax cuts in recent history and a ballooning of the national debt, many were left wondering, what happened to the conservative economic principles that were used to admonish the previous administration? In a February 26th editorial, *Barron's* viewed the passing of the Act as "standing history on its head." Instead of reducing national debt as the economy recovers from a recession, this plan cuts taxes to encourage spending and increases government debt. In doing so, it encourages inflation instead of eschewing it, a departure from what the U.S. has done in the past.

As has been widely reported, the Act has many aspects that will impact individual taxpayers both positively and negatively, depending on their individual circumstances. However, for companies, the Act appears to be a boon, especially for large international corporations, such as those that we hold in our clients' portfolios.

President Reagan signs the Tax Reform Act of 1986. The Act shifted a large part of the tax burden from individuals to corporations.

Source: NPR, US Federal Government

As the price of a stock is related to its earnings, understanding how this change to corporate taxes will impact stocks is critical for any investor. The last time the U.S. tax code was changed was in 1986, when President Reagan, "simplified" the tax code. We are not sure if Reagan actually simplified the tax code, but we are certain that the Tax and Jobs Act of 2017 has made it more complicated!

There are several elements of the Act that will benefit corporations. One of the most widely reported is that it cuts the corporate tax rate from 35% to 21%, bringing it closer to Canada's 15% corporate rate, or Ireland's 12.5% corporate tax rate. Another element of the Act addresses how companies account for profits earned outside the United States.

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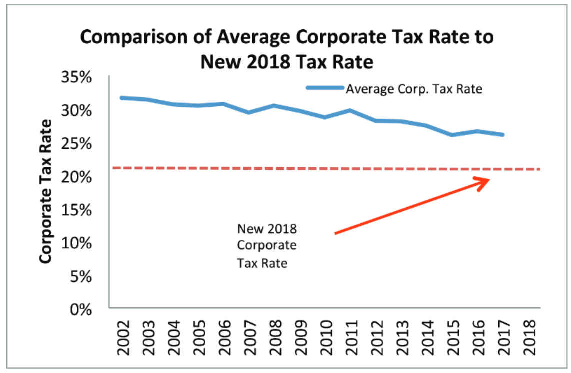
For years, American companies have been hoarding overseas profits in foreign bank accounts in an effort to avoid a 35% tax that would have been placed upon them if they would have repatriated (returned home) these profits back to the U.S. It is estimated that approximately $2.6 trillion dollars has been sitting in overseas accounts. As a candidate for president, Donald Trump argued that the U.S. should embrace a policy to repatriate these monies, and that doing so would jump start the economy by letting companies keep more of their earnings to reinvest in the U.S. Therefore, one of the key features of the Act is to encourage companies that have stockpiled money overseas to repatriate it by assessing a lower one-time tax of either 8% or 15.5%. Already, several companies have announced plans to repatriate these monies which will cause them to incur this one-time tax.

For investors, the most significant part of the Act is its transition to a "territorial model" where companies pay the tax based on where the income was earned and not where the company is headquartered. Previously, the IRS required that income from corporations be taxed on a "worldwide" model, where U.S. businesses were taxed on all of their income, regardless of where it was earned. This "worldwide" model incentivized companies to reclassify profits made overseas in an effort to avoid paying the U.S. tax rate. With the change to a territorial model, companies are required to pay taxes on profits only in the country where they were earned. Effectively, this means that if an American company makes profits overseas, it will owe no taxes to the U.S. for that portion of their earnings.

Finally, as mentioned above, the Act lowers the top corporate tax rate from 35% to 21%. By lowering the corporate tax rate for profits made in the U.S. and shifting to a territorial tax model for profits made outside the U.S., the Act will provide significant cuts to corporate taxes. We estimate that the after-tax earnings of many companies could increase by over 20% as a result of these changes.

In 2012, we reviewed the tax rates of the companies in our clients' portfolios and have updated the chart to 2017. Over this period, these companies have collectively seen a reduction in their tax rate. In fact, the average tax rate for this group has fallen from 31.6% in 2002 to 26.1% in 2017. If this group of companies pays the corporate tax of 21% for 2018, their Federal taxes will have declined by 20%. Since dividends are paid from after-tax earnings, there is reason to believe that the companies that we select for our clients will use a portion of this tax savings to significantly increase dividends. If this occurs, share prices of these companies should increase as well, reflecting the higher dividend yield.



While the corporate tax cut may benefit shareholders of dividend-paying stocks, and shareholders in general, a larger question remains: will the tax cut result in increased investment by these companies that could lead to higher incomes for middle class workers and facilitate a growing economy, or will companies use these monies to simply repurchase shares, lower their debt and reward shareholders?

While critics of the Act have referred to it as a departure from history, not everyone sees this as a negative. Despite the fact that the U.S. economy has recovered from the recession, it has not experienced robust growth. As we pointed out in previous newsletters, the U.S. economy was stuck in a disinflationary cycle. By increasing corporate spending, the Act *could* lead to higher inflation rates. As *Barron's* noted, higher inflation may enable the government to pay down its debt using inflated dollars, making it easier to pay down. It is a bold plan. Intelligent investors would be wise to see the short-term benefits of this Act while keeping a close eye on a nation that has turned history on its head.