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MACROCOSM

Tax Cuts: Smells Like Victory (For Some more than Others)

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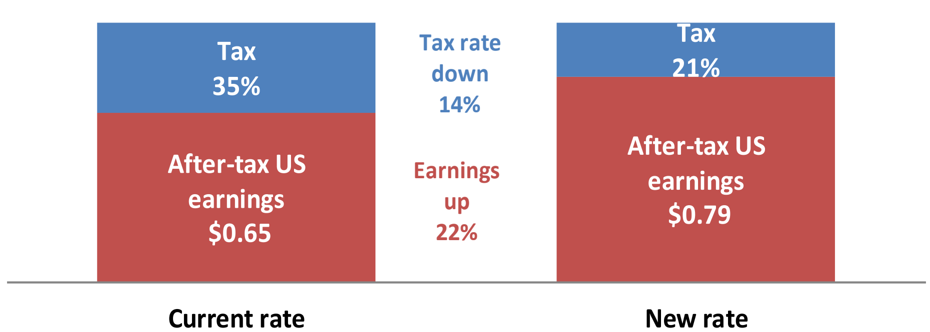
We answer clients' questions about winners and losers under the Tax Cuts and Jobs Act.

Almost there. There's many a slip twixt the cut and the lip – so we're not quite ready to shout out a big "We told you so!" *But it sure seems like President Donald J. Trump's signature legislative initiative – a massive corporate tax cut – is about to become reality. The conversation is changing from "Will it happen?" to "Okay, it's happening – now what does it mean for markets?"* There are so many moving parts in this sweeping legislation (the Conference Committee's report contains a 503-page bill and a 588-page analysis of it), we hardly know where to begin. So we'll build this report around the questions we've been getting from clients.

WHAT COMPANIES WILL BENEFIT MOST FROM THE CUT IN THE TOP CORPORATE TAX RATE FROM 35% TO 21%? This is an easy question. The first-order effect of the cut will be to bestow a windfall gain on after-tax domestic earnings. *The gain will be in proportion to the US-derived share of a company's net income. It's only a cut on a company's US taxes, not its foreign taxes.*

- All else equal (and subject to things we will discuss in a moment), 65 cents of after-tax US earnings ($1 minus 35% tax) becomes 79 cents ($1 minus 21% tax), for a gain in after-tax earnings of 22% (please see the chart below).

Impact of lower corporate tax rate on $1 of US earnings



Source: TrendMacro calculations

- *So if 50% of S&P 500 earnings are US-derived, then S&P 500 earnings should rise by 11% with the stroke of President Trump's*

Update to strategic view

US STOCKS, US BONDS, US MACRO: A massive corporate tax cut is almost across the finish line. On first-order effects the big winners are companies with domestic net income, which will rise on an after-tax basis by 22% with a stroke of Trump's pen. It's obvious to us that these tax cuts will "pay for themselves." Companies with backlogs of unpaid taxes on foreign income will be hurt by the "deemed repatriation" tax. Companies using international tax arbitrage will lose that relative advantage under base-erosion provisions. Over time, after-tax margin windfalls will be competed away, but that increases the size of the economy and preserves higher after-tax dollar earnings. Higher growth prospects will protect bond yields from possible deflationary effects. Not preserving the SALT deduction was an unexpected political bargaining failure, leading to tax hikes for high-earners. Over time, nevertheless, their after tax incomes and wealth will likely still rise.

[Strategy dashboard]

pen. That's an over-simplification, but it's probably not wildly divergent from reality – subject to the next question.

WHAT COMPANIES WILL BE HURT? Provisions of the bill designed to "pay for" the cut from 35% to 21% will definitely hurt certain companies.

- *Companies with foreign earnings parked overseas will have to pay taxes on those earnings all the way back to 1986, whether or not they repatriate them.* The tax rate on liquid assets, such as cash, will be 15.5%, and on illiquid assets 8%, payable in installments over eight years.
- Such payments would offset any tax cut windfall with respect to current US earnings. *So the larger a company's back-log of unrepatriated foreign earnings in relation to its current US earnings, to more it stands to be hurt.*

WILL "BASE EROSION" PROVISIONS REDUCE AFTER-TAX EARNINGS OF COMPANIES LIKE APPLE? Apple is notorious for locating patents in its Irish subsidiary, and paying royalties to it from the US – an arbitrage that effectively shifts US income taxable at 35% to Irish income taxable at 12%. Other global companies have similar strategies. In 2018, such transfer payments would be taxed at 5%, rising to 10% in 2019, and 12.5% in 2026.

- A company will still get the windfall gain from the reduction of taxation on any US income not transferred to Ireland.
- But that will be offset by a tax hike on US income transferred to Ireland, from 12% to either (a) the US rate of 21% (if the transfers cease), or (b) 22% (if the transfers continue, and the Irish tax of 12% *and* the US base erosion tax of 10% are both paid).
- *We estimate roughly that base erosion provisions would reduce the after-tax earnings of a company like Apple only if, historically, more than about 60% of US earnings had been transferred to Ireland.* If *less* than 60% of US earnings had been transferred, or if transfers had been made to another country with a higher tax rate than Ireland's (but still lower than the US tax rate), then such a company would not see a reduction in after-tax earnings.
- *But any company like Apple – which has been utilizing to any extent this tax arbitrage that is now being eliminated – will realize less of an increment to after-tax earnings that a company that has not.*

ISN'T THIS JUST A SUBSIDY FOR OLD-LINE AMERICAN COMPANIES? The windfall gain on after-tax domestic earnings is most intense for established, profitable, domestic-focused businesses. But that is only the first-order effect, what we have called the "demand-side channel" (see "Delayed Gratification for Corporate Tax Cuts" November 20, 2017).

- More important over time will be what we have called the "supply-side channel." A lower marginal tax rate creates advantages to

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companies that are not yet profitable (and therefore not even paying taxes presently), because it removes a barrier from undertaking innovative competitive initiatives. *We can't guess, here in the present, what new initiatives will be able to be born in the future when their planners know that their returns will only be taxed at 21%, not 35%.*

- *It stands to reason that, at the margin, such initiatives are likely to come from smaller, nimbler, more innovative firms*.
- *Furthermore, those new initiatives could come from non-US firms that, under the new lower tax rate, now find it feasible for the first time to invest in the US.*

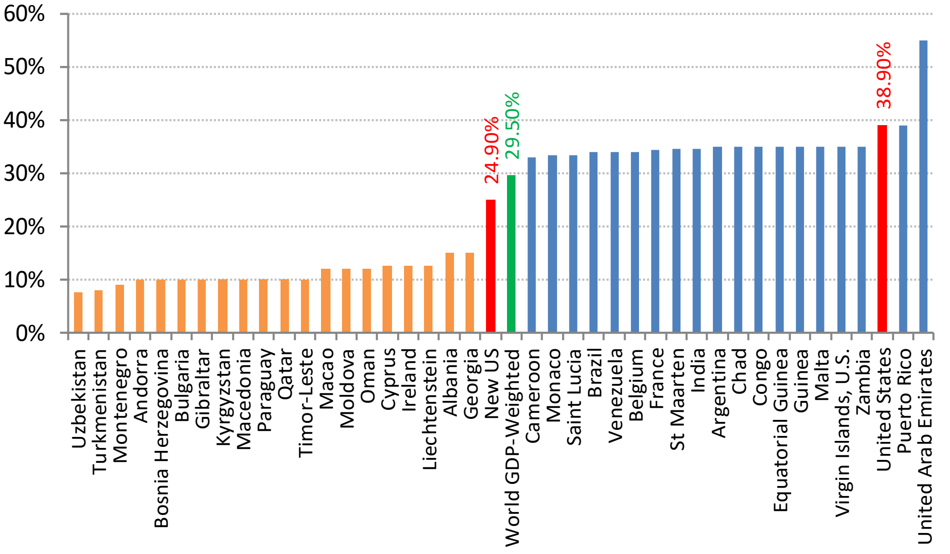
WILL THE CORPORATE TAX CUT BE COMPETED AWAY? Another way to put it is, won't firms spend their windfall after-tax earnings gains to compete for market-share? This is a very profound question with no determinate answer.

- As an abstraction, we think the answer is "yes, but" – and "only over a long time."
- Think of the tax cut as an upside shock to profit margins across all firms. Assuming stable capital market requirements for margins, firms should compete on price, wages and capital investment in an attempt to gain market share, until margins are right back where they are now.
- But that's not to say that after-tax earnings will come back to where they are now. *The reduction of the deadweight loss of taxation should increase the unit-volume of economic output and its consumption which, at any given level of profit margins, would imply a higher dollar value of after-tax earnings.*
- Another way of seeing this would be to think of the removal of the deadweight loss of taxation as an endowment that will end up being shared by a variety of stakeholders – workers, customers, shareholders – based on what turns out to be their relative bargaining power under competition. This insight is the key to understanding why *the corporate tax cut will increase overall well-being in the economy – higher wages, higher consumption, and so on – beyond simply conducting money from the Treasury to corporate shareholders.*

IF CORPORATE TAX CUTS STIMULATE COMPETITION, WILL IT BE DEFLATIONARY? We understand the spirit of this question, and are not unwilling to believe that a large corporate tax cut could stimulate price-competition that would lead to lower inflation. But if we have learned anything from the Great Recession and its aftermath it is that we don't really know what causes inflation nor even how to measure it. We'll only say that we think this is a serious question that deserves careful watching.

IF CORPORATE TAX CUTS ARE DEFLATIONARY, WON'T THEY LEAD TO LOWER LONG-TERM BOND YIELDS AND AN INVERTED YIELD CURVE? If it turns out that the tax cuts are deflationary, then necessarily that would work to lower long-term bond yields. *At the same time, we think*

Comprehensive corporate tax rates ■ **Lowest** ■ **Highest**



Source: Tax Foundation, TrendMacro calculations

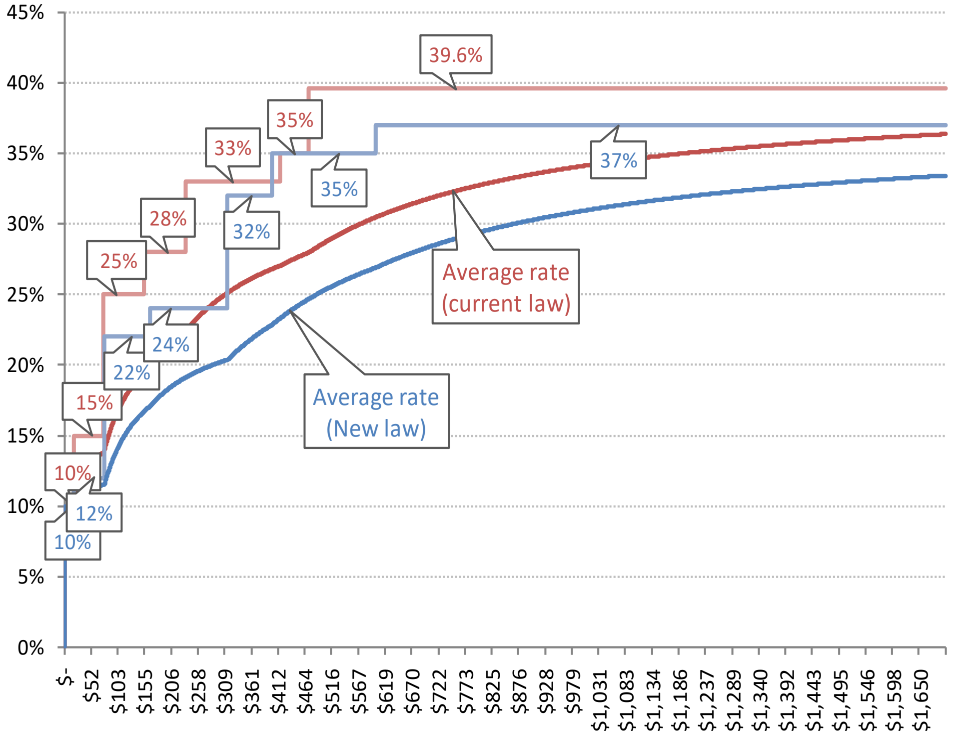
that cutting the US corporate tax rate from the highest in the world to below the GDP-weighted average (please see the chart above) *should be a powerful spur to faster growth, which may contribute more to increasing the term-premium component of yields than, any deflationary effects would contribute to decreasing the inflation-compensation component.* We feel more confident about forecasting a higher term-premium than we do about forecasting lower inflation-compensation.

WILL THE TAX CUTS "PAY FOR THEMSELVES"? The assumption by the Joint Tax Committee of 1.9% *real GDP growth per annum, over the coming decade, would only have to be increased by about 40 basis points for the entire package of tax cuts and tax hikes to be self-financing* by the end of the 10-year budget window. It seems obvious to us that this can be easily obtained – and likely exceeded.

I LIVE IN CONNECTICUT. WHY AM I SCREWED? All but the lowest-earning individual taxpayers will see a reduction in their headline federal tax rate on ordinary income (please see the chart below). *For higher-earning taxpayers, much, all, or more than all of that tax cut is offset by the loss of the deductibility of state and local taxes (SALT). It's enough to make you believe Treasury Secretary Steven Mnuchin's much-mocked claim that these tax cuts won't help the rich.*

- *While the overall package of tax cuts is pro-growth, this is their most problematic single element.*
- It's only a problem for taxpayers who itemize deductions – and with the proposed law's expansion of the standard deduction, that's only about 5% of taxpayers. Within that 5%, the lowest earners can still deduct up to $10,000 from adjusted gross income (choosing between deducting property tax or income tax), which preserves

Tax rates, individual ordinary income, filing jointly, by AGI ($ thousands)



Source: Conference Committee, TrendMacro calculations

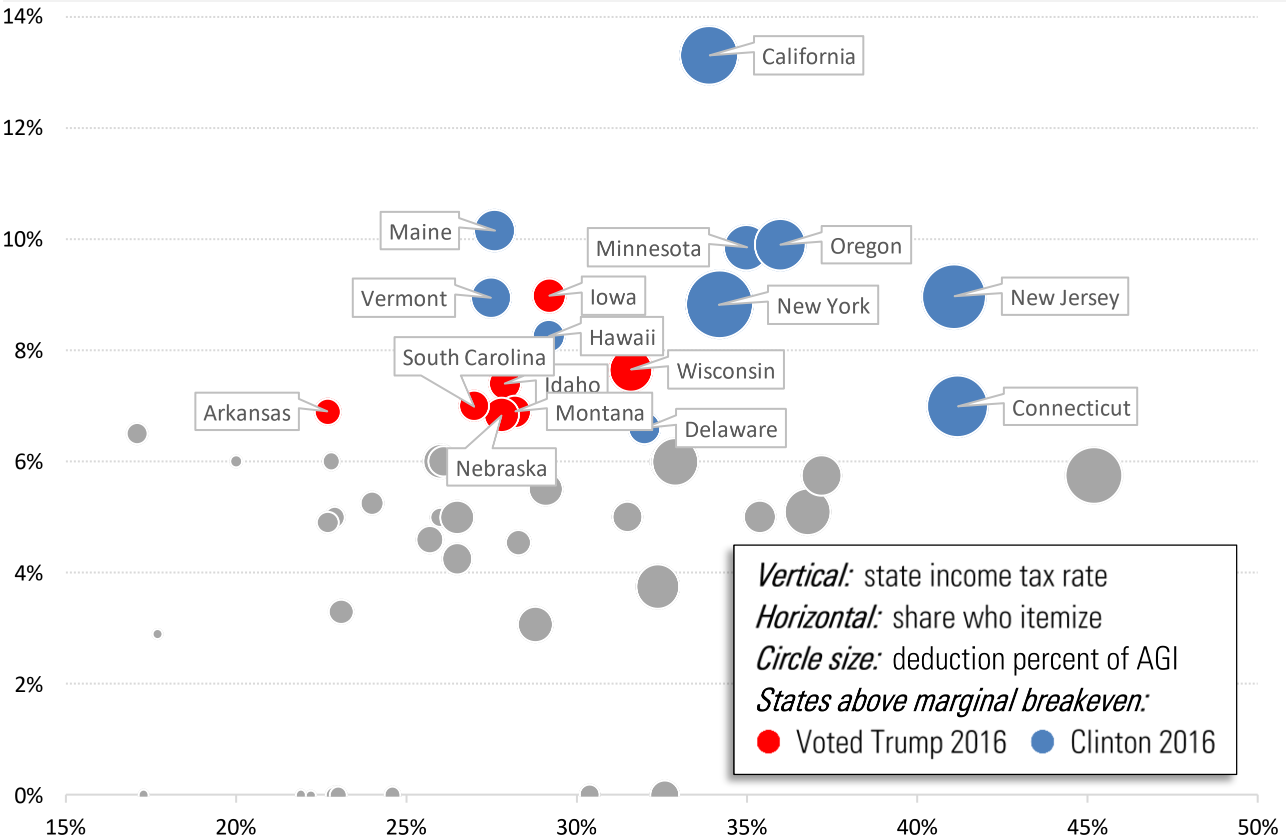
much of the benefit. Here's how to think about it, at the margin, for the *highest* earners.

- The top marginal rate falls from 39.6% (kicking in at $470,700 for couples filing jointly) to 37% (kicking in at $600,000). That's a reduction in the top rate of 6.56%. If your state's top tax rate is *below* 6.56%, you still get a tax cut at least to some degree. If your state's top tax rate is above 6.56% – as it is, in ascending order by tax rate, in Delaware, Nebraska, Arkansas, Montana, Connecticut, South Carolina, Idaho, Wisconsin, Hawaii, New York, Vermont, New Jersey, Iowa, Minnesota, Oregon, Maine, and California – then you will probably experience a tax hike in 2018.
- *But we urge clients to remember the important thing is not how much your taxes are reduced, but how much your after-tax income and your wealth rise.*
- It is possible, indeed likely, that the pro-growth effects of the corporate tax cut could boost individual incomes and wealth sufficiently so that, even with an effective marginal tax hike as a result of the loss of the SALT deduction, one comes out ahead.

DIDN'T YOU SAY THAT THE SALT DEDUCTION WOULD BE PRESERVED IN LAST-MINUTE BARGAINING? We sure did (see "Trump's Tax Cut Nuclear Option" May 1, 2017). And it looks like we're going to be wrong about that. *This is an unexpected and unfortunate political bargaining failure. It's the worst part of an otherwise pro-growth tax bill.*

- 10 blue states and 7 red states have tax rates above the 6.56% threshold, at which the loss of the SALT deduction more than offsets the reduction in the top federal rate.

Dynamics of the state and local tax deduction



Source: IRS, Tax Foundation, TrendMacro calculations

- That's more blue states than red, and the blue will be more hurt by it (see the chart below). But for the GOP that's only a Pyrrhic victory – there are unacceptable losses on *both* sides.
- *Again, we think this is the result of a political bargaining failure.*
- We have always known that the threat by the Trump administration to eliminate the SALT deduction was a negotiating ploy to enlist Democratic support for larger tax cuts outside of the boundaries of the "budget reconciliation" procedure in the Senate (see "Trump's Tax Cut Nuclear Option" May 1, 2017). It was a hostage-taking exercise, because the SALT deduction is much more valuable, generally, in predominantly Democrat-leaning states. But there are Republicans who live in blue states, and a few red states with high tax rates. *So it was a game of mutually assured destruction – but unfortunately nobody blinked. Now everyone loses.*
- Looking back on it, it all started to go wrong when the House first released its version of the Tax Cuts and Jobs Act, preserving the SALT deduction to the extent of $10,000 in property taxes. For Democrats, this was enough to take out the worst of the sting – the penalty that would fall on the mass of middle-class voters.

- At the same time it was a sign of weakness for the GOP, indicating they were not willing to put their own middle-class voters at risk for the sake of compelling Democrats to surrender.
- Apparently Democrats went into the end-game making the calculation that at least its low-earning base was protected by the concession the GOP had already made – and willing to cause some pain for its high-earning elite in what will likely turn out to be the vain hope that the GOP didn't have the votes in the Senate to pass TCJA, or if it did, that the loss of the SALT deduction could be used as wedge issue with big donors in 2018.

Bottom line

A massive corporate tax cut is almost across the finish line. On first-order effects the big winners are companies with domestic net income, which will rise on an after-tax basis by 22% with a stroke of Trump's pen. It's obvious to us that these tax cuts will "pay for themselves." Companies with backlogs of unpaid taxes on foreign income will be hurt by the "deemed repatriation" tax. Companies using international tax arbitrage will lose that relative advantage under base-erosion provisions. Over time, after-tax margin windfalls will be competed away, but that increases the size of the economy and preserves higher after-tax dollar earnings. Higher growth prospects will protect bond yields from possible deflationary effects. Not preserving the SALT deduction was an unexpected political bargaining failure, leading to tax hikes for high-earners. Over time, nevertheless, their after tax incomes and wealth will likely still rise.