CREDO WEALTH

Pulling fuzzy strings

The United States houses of Congress released their respective tax reform draft bills earlier this month and the House of Representatives passed its bill this week. Tax codes are politically contentious, and unclear for investors too. As much a means of earning revenue for the government, they are also used to pull strings. Different interest groups want different strings pulled. The stated aim of the new legislation being proposed is that it is “intended to lower the rate for manufacturing companies making widgets and employing other people” (Rep. Chris Collins (R., N.Y.)). The Republican belief is that by reducing tax, the incentive is there to invest, hire and grow.

Due to the uncertainty surrounding the current administration, higher tax stocks have not outperformed since the 2016 Republican victory. This is despite the prospects of tax reform. Plans must go through both houses of Congress (the House and the Senate) and are likely to change repeatedly. The bills unavoidably contain sticking points that require horse-trading between legislators. Although there are significant areas of disagreement in the Republican Party, from trade and infrastructure to health reform and immigration, a net tax cut is one area on which they generally agree. Prediction markets suggest there is an increasing belief that agreement on tax cuts may be found in Q1 2018. A significant legislative achievement would also be of benefit during difficult 2018 midterm elections.

That it is contentious is in part due to the complexity of the tax codes and in part the uncertainty of the impact of changes. It is not completely clear who benefits, directly or indirectly. The same amount of money is taxed differently depending on how it was generated. There is different treatment for salaried employees, investors, manufacturers, owners and those who inherit money. For some, it is clear, for others the amount they pay will depend on their ability to argue, and their knowledge of what they can say.

Currently, the legal corporate tax rate is 35%. The top end personal tax rate is 39.6%. The thorny issue is that reducing corporate tax rates also (in effect) reduces the tax on individuals who are owners rather than employees. What some (on the Republican side) see as improving incentives, others see as unfair favouritism (on the Democrat side). Some early estimates suggest on the current plan tabled, $1 trillion worth of cuts will go to businesses, $228 billion to individuals, and $172 billion to estates. ‘Go’ being fuzzy.

What is clear is that a hypothetical company presently bearing the full tax burden of 35%, could see their earnings boosted by ~23% (assuming on $1 of pre-tax income, they currently earn 65c of after-tax profit; whereas post reform they’ll earn 80c of after-tax profit). In contrast, individuals across the various income groups might see their after-tax incomes boosted by a relatively meagre 0.5% to 3.25% (according to estimates from Goldman Sachs and the Joint Committee on Taxation).

In a competitive market, a reduction in tax doesn’t necessarily mean a company with a reduced tax bill will make more profit. Over the medium-term, companies in these environments can “give up” much of the benefits to customers in the form of lower prices. If, however, companies have pricing power, and their competition pays little or no tax already (e.g. charities or government), there could be a sustainable benefit. Private hospitals and for-pay education for example. The upside favours two groups of companies on a relative basis. Those that are heavily taxed and those that currently have the most cash held overseas that could benefit from a repatriation tax holiday.

As investors, it is fortunately not our job to answer thorny, possibly unanswerable questions around incentives and fairness. Still, we must be aware of the upside, and downside, faced by the companies in which we invest should the rules change.

One thing that doesn’t change, is that rules change. Rather than predict the direction, it is better to prepare.

Important notice