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2018 New Tax Law – Potential Market Results

Solid Economic Growth Continues

New Tax Law Quick Facts – Some not widely realized yet

The Bull Market's Next Act - 2018 Outlook

Economic Stimulation vs. Deficits

Some economists and many Republicans believe added economic growth from the tax cuts will more than make up for the tax cut cost of $1.5 trillion. The Tax Policy Center estimates the growth will only recover about $500 trillion.

"While Republicans claim that the benefits to corporations will ultimately trickle down to the working class through pay raises and job expansion, many economists are dubious, as previous tax breaks have not borne this out," reports Barron's 12/25/2017.

While the corporate tax cuts are permanent, the individual cuts expire after 2025. Republicans assure folks they will be extended. However, an extension would increase the deficit to about $2 trillion in total over 10 years and the high cost would continue as long as the lower rates were in place.

If the growth does not come quickly, how can we increase further defense spending, much-needed infrastructure (we have some of the worst old airports, roads, and bridges in the developed world) and more funding to support health care, social security, etc.?

With the U.S. economy near full employment, economists argue that the tax cuts will only provide a modest boost to growth. The Trump administration argues that the tax cuts will boost both business and consumer spending. But the individual income tax cuts are skewed toward higher-income households, which economists say have a low propensity to consume. (Reuters 12/22/2017) Dave notes that higher-income households tend to save and invest more than consume, which could be positive for equities.

About 84% of stock values are owned by the richest 10% of American households (Time 12/19/2017).

April 2018 Update - In addition to the tax cuts, with the Republican spending bill that passed, the Congressional Budget Office on 4/09/18 forecasted a deficit of over $800 billion in 2018, climbing to annual deficits of at least $1 trillion for 9 consecutive years beginning in fiscal year 2020.

Debt held by the public will stand at a staggering $29 trillion by 2028, prompting a warning from CBO Director Keith Hall. "Nobody knows what's too much debt — what will cause a fiscal crisis," he said, detailing the grim news. "The bigger the debt, the bigger the chances of a fiscal crisis."

Impact on 4th quarter earnings with deferred tax adjustments

The impact of the tax cut on corporate deferred tax liabilities may result in a significant one-time gain or loss in fourth-quarter earnings.

After the fourth quarter non-cash adjustment to earnings, the permanent large corporate tax cut will shower many companies already flush with cash with more profits - most of which are expected to benefit investors by stock dividends and buybacks. A few companies that want to gain favor from the administration are tossing out a small portion of the expected windfall in one-time bonuses (often $1000-1500) to existing workers.

The extent of the tax reduction will vary widely. Only a small percentage of corporations pay the prior highest rate of 35%. After average deductions and credits, the effective average rate is 18.6%. (Tax Foundation)

The new tax law lowers the top corporate rate from 35 percent to 21 percent. The lower tax scrambles the math around deferred tax liabilities, meaning some companies will post significant one-time gains or losses as they must bring their books into harmony with the new code by year-end.

Bloomberg 12/22/2017 reports Biotechnology giant Amgen said it would take a $6 billion to $6.5 billion charge. Bank of America Corp. plans to take a $3 billion hit and Citigroup estimates a

charge-off of about $20 billion which will reduce fourth quarter earnings.

A further complication of picking winners and losers is that for highly leveraged companies the rate cut will be offset since the business interest expense deduction will be limited to 30% of income. There are some complications regarding how interest is defined, some dodgy workarounds for pass-through businesses, and an exemption for real estate debt.

Many stocks had trading halted on Friday 12/22 due to “news pending” – even those with relatively minor required tax adjustments.

For example, Mallinchkroft - a global specialty biopharmaceutical company. This stock was halted pre-market on Friday 12/22 on a breaking news story. It reopened for trading after its press release saying "The GOP's Tax Cut and Jobs Act will be neutral to modestly positive on its non-GAAP tax expense. If enacted, as expected, it will have a deferred tax benefit of $450M - 500M mainly associated with a reduction in its interest-bearing U.S. deferred tax liabilities ($1.6B as of the end of September) to reflect the reduction in its federal income tax to 21% from 35% effective January 1, 2018. The beneficial impact of the lower tax rate will be mostly offset by tighter limitations on interest rate expense deductions.”

A deferred tax liability is an account on a company's balance sheet that is a result of temporary differences between the company's accounting and tax carrying values, the anticipated and enacted income tax rate, and estimated taxes payable for the current year.

Cfo.com on 12/22/2017 reports a study showing 809 U.S. public companies with reported deferred tax balances. 548 would have a liability reduction of $142.4 billion (so boost in income and equity) and 261 will have assets drop by a total of $38.2 billion. However, this study was from 2015 based on the Obama proposed rate cut to 28% - far less of a reduction than the new tax law's 21%. This could make more companies having larger required earnings adjustments.

The law firm Elliott Davis issued an alert on 12/22/2017: "We note that for SEC registrants, there may be a requirement to file Form 8-K within four business days to report any material impairment of deferred tax assets as a function of the reduced corporate tax rate. As a result of the timing of the enactment of this Act, Companies will include the tax impact in the financial reporting period that encompasses the enactment date." (Enactment date was 12/22).

President Trump could have kicked the enactment into next year for first quarter reporting, but chose not to, since he wanted to give us the tax cut as a Christmas present.

Solid Economic Growth Continues

The overall U.S., as well as global economic trends, continue quite positive.

The U.S. manufacturing sector is especially strong with a record level of industrial production surpassing the previous peak in 2007 before the Deep Recession. With automation, however, factory employment is down 1.5 million jobs from 2007 (IndustryWeek 12/21/2017).

On 12/14/2017 it was reported that November retail sales grew more than estimated, signaling a broad strengthening in consumer demand. October sales were also revised upward. Moreover, the "control group" retail sales over the last three months were growing at the fastest rate since June 2014. The "control group" excludes autos, gasoline and construction materials.

U.S. consumer spending accelerated in November and shipments of key capital goods orders increased for the 10th straight month, the latest signs of strong momentum in the economy as the year winds down (Business News 12/22/2017).

This, of course, is potentially good for us investors and those with retirement accounts invested in equities.

New Tax Law Quick Facts

Forbes says, "Neither snow nor rain nor crippling deficits nor a monumental upset in Alabama stays these Republicans from the swift completion of passing a tax bill that few understand and even fewer seem to want."

In the last-minute rush to pass in the Senate, it managed to make a $289 billion mistake, killing off the research and development credit that it intended to keep. The Senate had to correct the error and send it back again for another vote in the House.

The bill is 1,097 pages including 503 pages of legislative text. The law is very complex and may

keep tax lawyers busy finding loopholes and the IRS busy writing regulations for years.

Under the new tax law, hedge funds were big winners since the carried interest tax advantage that Trump promised many times to get rid of was not repealed.

In addition to the corporate tax cuts when overall profits are already at record levels, 65.3% of the individual tax benefits will go to the top 25 percent of taxpayers and 20.5% to the top 1 percent. (Tax Policy Center.) This does not include the doubling of the estate tax exemption and other provisions that benefit the wealthiest.

Real estate owners get another big benefit from the 20% additional deduction with the pass-through provision since most large real estate owners - like Trump and son-in-law Jared Kushner, - operate as LLC's or partnerships. This provision was not in either the final House or Senate bills but was included in the conference bill that was made law.

Sen. Bob Corker (R-TN) would also personally benefit from the new provision. Corker opposed the Senate version of the bill, citing deficit concerns, but announced his support for the final tax legislation, even though it has the exact same deficit impact. Other special deals were made to a few other holdouts to be sure it passed the Senate.

The pass-through 20% deduction also applies to many small businesses. Two-thirds of pass-through entities are owned by the top percentile of taxpayers. (Barron's 12/25/2017)

Most low and middle-income taxpayers will have a small tax cut until 2025. However, while the standard deduction for those who do not itemize is doubled, personal exemptions are eliminated so a family of 3 or more will have fewer deductions than under current law.

Capital gains taxes remain the same, but the tax brackets are based on the old bracket income ranges, not the new. This may result in taxpayer confusion and a more complex Schedule D.

No more deduction of investment expenses which had been allowed if in excess of 2% of adjusted gross income. This will mean some folks using fee-only planners will no longer get the deduction for a typical 1%-2% annual fee on hopefully increasing asset values each year. In our view for long-term growth investors, this is the most expensive way to get investment advice even when it was deductible vs. one-time brokerage fees only on initial investments.

If you are saving for your child's education in a 529 plan like we recommend, the new rules let you use up to $10,000 per year not just for post-high school costs, but now includes K-12.

The Kiddie Tax has been tweaked for child's unearned income. Previously, kids paid taxes at their parents' rate on unearned income over $2100. The new law for capital gains applies the same capital gains rates that estates pay on children's unearned income. For ordinary income such as interest, short-term gains and dividends, the higher normal trust tax brackets are used. Confused yet?

The exemption has increased for the Alternative Minimum Tax (AMT), which benefits those with higher incomes. The AMT is very complex and in my view, it simply should have been repealed.

"The varying new benefits and rates on individuals, pass-through and corporate income sets the stage for years of scheming and mining through the tax code for new ways to game the system," reports Barron's 12/25/2017

Estate/Gift Tax (Uniform Transfer Credit)

President Donald Trump's vow to kill the federal estate/gift tax failed, but his family and other high-net-worth families should benefit from the new $22.5 million exemption (with portability between couples) that will be indexed for inflation but expires after 2025 like the rest of the individual tax cuts.

Most planning opportunities will be next year: The increased estate-tax exemption will prompt a flurry of estate-planning revisions.

Estate planning ideas for married clients with more than $22.5m from Forbes:

1) Make gifts to existing or new irrevocable trusts, including generation-skipping trusts.

2) Leverage gifts to support the funding of life insurance or existing sales to trusts.

3) Pairing gifts with philanthropy (such as a charitable lead trust).

The tax law doesn't make changes to the rules that step-up basis at death. That means that when you die, your heirs' cost basis in the assets you leave them is reset at the value when you die.

However, in community property states like Arizona, you will not get the full step-up unless you title assets correctly. Holding as joint tenants will not provide the desired full step-up.

The Bull Market's Next Act - 2018 Outlook

Highlights of Barron's 12/9/2017

Given the synchronized global growth and rising corporate profits, 2018 could be another good year for stocks, notwithstanding the bull's advancing age. Most estimates assume that global growth will spur earnings gains, with an additional boost coming from U.S. tax cuts. "Rational exuberance" is the stock market's theme for 2018.

With interest rates still near historic lows almost a decade after the financial crisis of 2008-09, stocks have had plenty of runway for growth. Most strategists expect rates to rise in the next year, but not to levels that would imperil the bull.

While the Street's seers believe the market has already discounted about half of the expected tax relief, the tax bill could be a gift that keeps on giving. JPMorgan's chief U.S. equity strategist, says the impact on corporate earnings "will resonate in the first and second quarters of 2018…and continue to be a positive tailwind [for stocks]."

The outlook isn't entirely rosy: Interest rates are headed higher, and stocks are expensive. The S&P 500 trades for 18 times the next four quarters' expected earnings, up from 17.1 times 12 months ago. But so long as corporate earnings keep climbing and the Federal Reserve raises rates in a measured way, the strategists see more room for gains.

Dave notes the S&P500's high price/earnings ratio would be substantially lower if the five "FAANG" stocks were not counted. FAANG is Wall Street slang for Facebook, Apple, Amazon, Netflix and Google (now a unit of Alphabet Inc.) Further, the estimate of the forward P/E of 18 was made before consideration of the tax cut savings that will boost earnings - which reduces the P/E ratio.

The FAANG's average P/E ratio is a whopping 115. But It's not just the FAANGs. The average P/E ratio of the 50 largest stocks by market capitalization in the S&P 500 Growth Index is 32 (OnWallStreet 12/21/2017).

The Barron's article continues:

So long as earnings are rising, rates are low, volatility is subdued, and every stock selloff is met with more buying, as happened again this past week, the bull will still rule over Wall Street.

Fans of overseas markets note that many are earlier in the earnings-recovery cycle. Jeffrey Knight, co-head of global asset allocation at Columbia Threadneedle Investments, notes that U.S. equities rank poorly on various valuation metrics when compared with international stocks, which suggests that the rest of the world will catch up. That said, European, Asian, and emerging market stocks have outperformed the U.S. in dollar terms in 2017.