Barron's

What Investors Can Expect From Tax Reform

By John Kimelman

December 2, 2017

As Senate Republicans moved closer to an overhaul of the nation's tax code, the prospect of sharp cuts to corporate taxes loomed larger.

Investors appear to like that scenario, and stocks have moved higher in recent months, helped in no small measure by expectations of tax cuts. Yet much work and obstacles remain. (As Barron's went to press on Friday, passage of a bill seemed likely, although a vote had not yet taken place.) The Senate and House bills would need to be reconciled, for one.

Still, as the tax reform effort enters its end game, it's time for investors to assess the stock market's true winners and losers and whether the legislation could even impact their lifestyle choices.

INVESTORS IN COMPANIES that ply their trade mostly in the U.S.—a list that includes small-cap companies, health-insurance providers, and even domestic airlines like Southwest Airlines (ticker: LUV)—should benefit greatly from what is arguably the signature provision of the bill: a steep drop in the top federal corporate tax rate, which now stands at 35%.

No wonder that small-caps and other domestic-focused companies gained value on Wednesday and Thursday as the odds of Senate passage of the measure grew. These companies tend to have higher effective tax rates than global companies that park earnings abroad.

The final corporate tax rate, along with other provisions of the legislation, will be determined by a conference committee of House and Senate lawmakers seeking to create a unified bill that could be voted out of Congress before Christmas.

Reconciling Tax Reform

In the coming days, a House-Senate conference committee will work to come up with a unified tax-reform bill for Congress to vote on.

	House Bill	Senate Bill
Corporate Tax Rate	20%	20% (starting in 2019)
Repatriation Tax Rate	14% (for liquid assets)	14% (for liquid assets)
State and Local Deductions	Eliminated except for $10,000 in property taxes	Eliminated except for $10,000 in property taxes*
Mortgage-Interest Deduction	Only on mortgages for primary residence under $500,000	Only on mortgages for primary residence and one other under $1,000,000*
Estate Tax	Exemption of $11.2 million**	Exemption of $11.2 million*

*All individual tax cuts for Senate bill expire at the end of 2025.
**Estate tax is completely repealed by 2024.
Sources: News reports; Tax Foundation; Tax Policy Center

On Friday, the Senate was expected to pass its version of tax reform on a largely party line vote, two weeks after the House passed its measure.

Though tech giants such as Apple (AAPL), Microsoft (MSFT), and Google parent Alphabet (GOOGL), and other multinationals currently enjoy relatively low effective tax rates, they will experience a huge windfall from the legislation's provision that could set the rate on taxes of foreign earnings held in cash as low as 10%, thus encouraging repatriation of hundreds of billions of dollars of overseas profits.

Most of that money, analysts say, will go to paying down debt and benefiting shareholders through additional stock buy-backs and increased dividends, rather than hiring new workers and expanding their business.

A number of executives have said as much in recent months, undercutting the notion advanced by GOP politicians, including President Donald Trump, that corporate tax break would bolster the job market and wages.

“An overwhelming majority of that overseas cash will be repatriated if tax reform is enacted,” says Scott Kessler, director of equity research with CFRA, an independent research firm. “The cash has to be domestic if these companies want to do stock buybacks and dividend increases.”

Plus, he adds, corporate decision makers won't put off acting on this new low rate on repatriated profits because “no one knows whether these tax cuts will be permanent.”

Tax reform is more of a mixed bag for some sectors of the market. For example, shares of home-builder stocks, particularly high-end builder Toll Brothers (TOL), initially faced pressure from a provision in the House legislation that limits the deductibility of mortgage interest on new-home loans of up to $500,000. The Senate bill sets the limit at $1 million. But that impact has been overstated since only a small percentage of homes in the U.S. have mortgages in excess of $500,000.

While shares of Toll Brothers fell 6% after the House Ways and Committee released its bill with a mortgage-interest cap on Nov. 2, the stock has recovered strongly in the following weeks. It's also not clear that final legislation will include such a cap on mortgage-related deductions.

“The market overreacted when it knocked down Toll Brothers and other home builders,” says Brian Bernard of Morningstar, who covers the sector. “Even if they lose a few home buyers because of a possible cap on mortgages, their cash-flow profile will still be a net positive” because they will benefit from lower corporate tax rates.

SIMILARLY, FEARS THAT the elimination of most state and local tax deductions will cause an exodus of the affluent in highly taxed states like New York, New Jersey, and California to low-tax states is probably overstated.

Carolyn Mazzenga, the national leader of the family wealth services practice of Marcum, an accounting firm, says that a New York City dweller who earns $1 million in ordinary income could end up paying a $35,000 to $40,000 more in taxes because of the loss of deductions.

“I have one client who has often talked about moving down to Florida, but now he's on a rampage because of this tax bill,” Mazzenga says. Still, she questions whether higher tax bills will necessarily cause a flight to low-tax locales. “They will rant and rave,” she says, but she wonders how many who didn't have the intention of moving to low-tax states in the first place would move simply because of this bill.

Investors will be watching how the final legislation shapes up in the House-Senate conference committee. Lawmakers could either phase in the corporate tax rate, as the Senate bill does, or set it higher than the 20% rate that Trump has long championed—perhaps at 23%.

In the end, says James Lucier, a managing director and tax-policy specialist at Capital Alpha Partners, the legislation “will largely deliver what investors thought it would from a corporate tax perspective.”