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INSIGHTS

Tax Reform: A Guide for Investors

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EXECUTIVE SUMMARY

- In December 2017, Congress passed the Tax Cuts and Jobs Acts ("TCJA").
- The legislation will have a material impact on individuals and U.S. corporations.
    - Corporations with high effective tax rates will likely be the primary beneficiaries of the tax bill.
    - Although the majority of individuals will likely experience a tax cut in 2018, the impact of tax reform on individuals will be disparate depending on an individual's unique circumstances.
    - We believe the tax cuts will likely provide modest stimulus to the economy over the short-term.
- While most of the focus from market participants has been on the bill's impact on the public equity market and individuals, other segments, such as fixed income markets, will be impacted as well.
    - We believe equity markets have been pricing in tax reform across various sectors for many months and, therefore, we would suggest that investors avoid making large sector bets within equity portfolios based on this legislation.
- Rocaton recommends that investors not make material changes to their strategic asset allocation targets as a result of tax changes.
    - Given that the TCJA lowered the corporate tax rate, taxable corporate investors (e.g. insurers or others with balance sheet assets) should reassess the relative value of tax-exempt assets.

Summary

The Tax Cuts and Jobs Acts is the most comprehensive piece of tax legislation since 1986. Figure 1 provides a summary of the major changes that will impact individuals and corporations. On the individual side, the important takeaways of the TCJA are as follows: 1) increases the standard deduction and eliminates personal exemptions, 2) places a $10,000 cap on property and state and local income taxes[1] ("SALT") in addition to eliminating other deductions 3) maintains seven brackets, but changes the rates and income ranges associated with each and 4) lowers the effective rate on pass through entities.

On the corporate side, the TCJA 1) lowers corporate tax rate to 21% (from 35%) and eliminates the corporate alternative minimum tax, 2) caps business interest deductibility, 3) allows for immediate expensing for capital expenditures, 4) moves to a territorial tax system and 5) allows for the repatriation of currently deferred foreign profits at lower tax rates than previously mandated. The balance of this paper outlines the potential impact on corporations and certain asset classes.

Impact on Corporations and Different Investors Types

Corporations

The TCJA will have a meaningful impact on the level of taxes that corporations pay. Some of the more meaningful and likely implications of tax reform on U.S. corporations are outlined below.

- After-tax corporate earnings and cash flow will grow as a result of the tax bill. Importantly, certain sectors that have a high current effective tax rates will

[1] Filers typically are required to choose between deducting individual income or sales tax.

Corporations (continued)

benefit more than other sectors that, on average, had an effective tax rate that was meaningfully lower than the 35% statutory rate (see Figure 2).
- In our opinion, the tax bill, all else equal, improves U.S. competitiveness and, at the margin, provides corporations a greater incentive to invest due to changes to the treatment of CAPEX, a lower tax rate and the repatriation holiday.
- GDP growth is likely to increase modestly, everything else being equal. However, given the U.S. is close to full employment and the output gap has largely disappeared, the impact on GDP growth may be less impactful than previous tax cuts. Though not our base case, there is the possibility that the tax cuts impact business confidence more than expected, potentially leading to more spending and investment and higher growth than predicted by most econometric models.
- Makes financing via the debt markets versus equity financing less attractive, which could impact future bond issuance and could impact demand/supply dynamics.

Figure 1: Summary of TCJA

Individuals

Individual Tax Provision	Effective Date and Type	Impact
Income Taxes	Effective Date: 1/1/18 and Sunsets in December 2025	Maintains seven brackets but changes the rates and income ranges associated with each. Lowers effective tax rate for most households in 2018.
Higher Standard Deduction/Elimination of Personal Exemption	Effective Date: 1/1/18 and Sunsets in December 2025	Fewer households will itemize. Lowers effective tax rate for most households in 2018.
Places a $10,000 cap on property and state and local individual taxes and eliminates other deductions	Effective Date: 1/1/18 and Sunsets in December 2025	Increases the potential for interstate migration.
Lower rate on pass through entities	Effective Date: 1/1/18 and Sunsets in December 2025	Introduces additional complexity. Likely benefits some small businesses.

Corporations

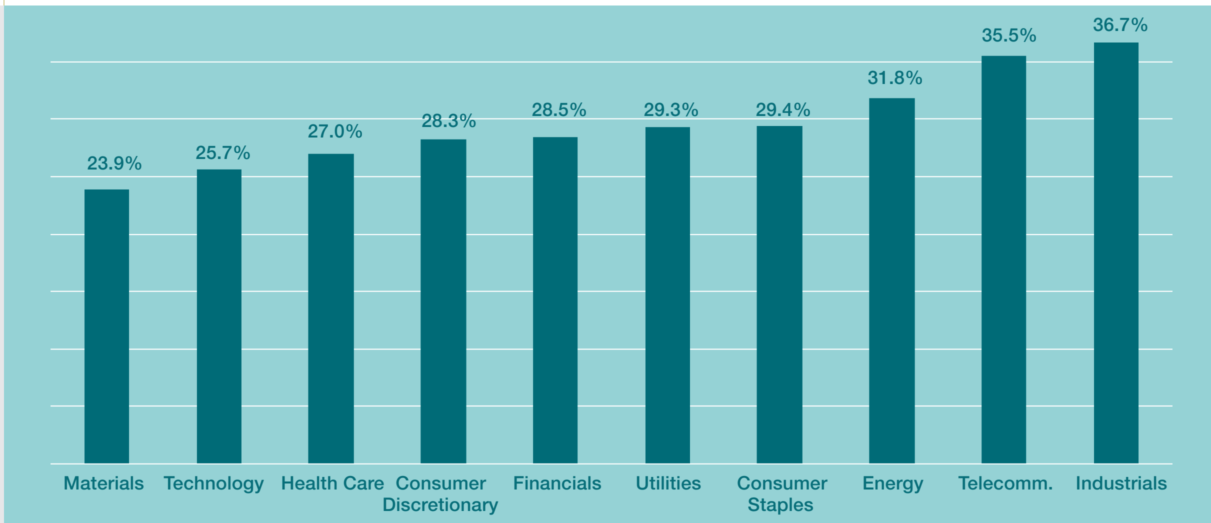
Corporate Tax Provision	Type and Effective Date	Impact
Lower Corporate Tax Rate	Effective Date: 1/1/18 and Permanent	Investors should look for dislocations in fixed income markets that may result from any proposed legislation or policy changes.
Cap on Business Interest Deduction	Effective Date: 1/1/18 and Permanent (EBITDA test from 2018 - 2021 and stricter EBIT tax thereafter)	Makes financing with debt less attractive at the margin. Likely hurts companies with high leverage ratios.
Expensing of capital equipment	Effective Date: 9/28/17 and Temporary; 100% expensing for 5 years and phased-out by 2026	Will likely increase investment at the margin.
Territoriality	Effective Date: 1/1/18 and Permanent	Moves U.S. from a worldwide to a territorial system of taxation.
Repatriation	Effective Date: 12/31/17 and One-time Tax	Likely will result in some combination of share buybacks, paying down debt and incremental CAPEX.

Corporate Defined Benefit Plans

Corporate plan sponsors should consider contributing to any defined benefit plans which are underfunded, particularly if the sponsor was planning to make contributions in the coming years. Although the new 21% corporate tax went into effect on 1/1/18, most plans can contribute through September 15, 2018 and still deduct the contribution at the old 35% corporate tax rate. Contributions to DB plans may be an appropriate use of capital when considering the deduction benefit along with rising variable rate PGBC premiums.

Figure 2:

Average Effective Tax Rate by Sector - Prior to TCJA



Source: Bloomberg. Based on data for S&P 500 companies.

Corporate Balance Sheet Investors

Many taxable corporations including insurance companies with significant balance sheet investments have historically used tax-exempt fixed income to enhance after-tax book yield and return. With the reduced corporate tax rate, tax-exempt fixed income has become marginally less attractive on an after-tax basis. We believe that municipal bonds still can offer strategic diversification benefits and relative value opportunities versus a taxable corporate universe. While the change in tax rules will impact each corporation slightly differently, we would suggest that taxable corporate investors, 1) re-evaluate their strategic weight to the tax-exempt market, and 2) potentially allow their investment-grade managers greater flexibility to opportunistically allocate between taxable and tax-exempt issues as the market digests the impact of the TCJA on supply, pricing, technicals and fundamentals.

Impact on Corporations and Different Investors Types

Municipal Bonds

The TCJA reduced the top income bracket for individuals marginally to 37.0% from 39.6%. Importantly, the final bill does not limit the amount of tax-exempt income an individual can receive. The confluence of these two factors likely results in demand from individuals for municipals remaining largely unchanged. Given the corporate tax rate has been lowered, at the margin, municipals become less attractive, on an after-tax basis, to taxable corporate investors (e.g. insurers and banks) which may shift the demand curve.

- The $10,000 cap on state and local income taxes and property tax deductions may potentially lead to interstate migration. Over the long-term, this may put incremental fiscal pressure on higher tax states some of whom are already facing fiscal challenges, which may lead to greater credit volatility.
    - * Scaling back the SALT deduction may create short term demand for bonds in high tax states.
- The TCJA eliminates the ability to issue tax-exempt advance refunding bonds, which will likely modestly impact supply. Advanced refundings allow an issuer to obtain the benefit of lower interest rates when their outstanding bonds have not reached their callable date.

Investment Grade and High Yield Corporate Bonds

At the margin, the TCJA makes financing with debt less attractive given it limits the deductibility of net interest expense to 30% of EBITDA from 2018 – 2021 and 30% of EBIT thereafter. While most large investment grade U.S. corporations are unlikely to be materially impacted by the cap, a meaningful portion of the high yield universe will be impacted[2]. Highly levered companies with capital structure flexibility will be incentivized to deleverage, particularly after year four. Companies with less financial flexibility may be forced to restructure. Investing with a skilled high yield manager that understands the implications of tax reform on individual companies is important.

Other Considerations

- <u>Retirement Planning</u>: Although highly publicized, the impact to retirement plans from tax reform is minimal. There is some speculation that lower tax rates may have potential indirect consequences for retirement plans. For example, having a reduced tax rate may reduce the value of tax incentives and could alter an individual's decision to contribute to a retirement plan. Alternatively, individuals may now have more money as a result of lower taxes and may redirect that money into retirement savings. There are also some that believe leaving deferral rates and retirement plans in general alone makes it less likely that contribution limits will be increased in the future.
- <u>Master Limited Partnerships ("MLPs")</u>: There is a marginal benefit to MLP equity holders in that individual tax rates are lowered and also there is a 20% deduction for individual MLP unit holders. The effective tax rate on earned income becomes approximately 29.6% before the Medicare tax. That said, a meaningful portion of the MLP distribution is not income, but a return of capital and ultimately taxed as capital gains which is not impacted by the changes to the tax code.
- <u>Private Equity/Real Estate</u>: The comments that were made in regards to corporations generally apply to the portfolio companies of private equity firms. Other notable changes include:
  - *Carried Interest*: Carry from investments held for under three years will be taxed at the higher ordinary income rate. Previously the threshold was one year. This is unlikely to have much of an impact given private equity firms tend to hold investments for more than three years.
  - *Pass-through income*: Raised the deduction to pass-through filers to 20% for qualified business income. The pass-through income deduction also applies to ordinary REIT dividends. At the margin, this is a positive for certain type of partnerships as it reduces the amount of income taxed at ordinary rates.
- <u>Treasury Issuance</u>: In our opinion, the TCJA likely leads to larger Federal budget deficits which in turn may lead to increased issuance of U.S. Treasuries. In isolation, increased issuance has the potential to push long-term interest rates higher. However, it is worth pointing out that there has been significant issuance of Treasuries post-financial crisis and long-term interest rates have failed to move higher.
- <u>Endowment Excise Tax</u>: The TCJA levies a 1.4% excise tax on universities with large endowments. At this point, it appears as though only a limited number of endowments will be subject to this tax.

Conclusion

As we have highlighted, this paper attempts to outline some of the more impactful elements of tax reform. Importantly, this paper does not represent an exhaustive overview of the TCJA. From our perspective, the bill's impact on corporations, investors and individuals will be idiosyncratic. Rocaton recommends that investors not make material changes to their strategic asset allocation targets as a result of the new legislation. We look forward to discussing with clients how the TCJA specifically applies to their unique situation.

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