Opinion: S&P 500 companies would save $87.1 billion if Trump passes his tax plan

By Michael Brush | Published: Dec 14, 2016

The president-elect realistically could lower the corporate tax rate to 20% from 35%

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He might as well just go all the way and dress up as Santa, too, as far as investors are concerned, because he will enter office bearing lots of potentially sweet presents for them.

By far the biggest: a huge tax cut for companies. Trump wants to reduce their tax rate to 15% from 35%.

He might not get that. Any reduction may more likely put the new rate at around 20%. That's because that is closer to the level often cited by Congressional Republican leaders, says Larry Puglia, who manages $55 billion in assets including the T. Rowe Price Blue Chip Growth Fund TRBCX, +0.81% Puglia was busy recently hunting for companies that pay high tax rates because they stand to benefit the most from a Trump tax cut, and for good reason.

Even a reduction to 20% would bring enormous benefits to investors. To gauge how much, consider this simple rule of thumb, says Bastiat Capital founder Albert Meyer, an accounting expert whose stock selections for investors are up 123% since April 2006, compared with 68% for the benchmark S&P 500 Index SPX, -0.20%

Theoretically, at least, the market capitalization, or value, of a company should increase by the dollar amount of tax saved multiplied by the company's price-to-earnings ratio. This is another way of saying that as earnings increase by the amount of tax saved, either the P/E has to go down or the stock price has to go up. This won't always be the case, of course, but it is a good rule of thumb.

As an example, Meyer cites Charles Schwab Corp. SCHW, -0.23% because it pays no foreign taxes. Schwab paid $734 million in federal taxes in 2015, for an effective tax rate of 32.2%. If that fell to 20%, the company might have paid $456 million in taxes, saving $278 million. Multiply Schwab's P/E of 25.5 by that $278 million in extra earnings and you get a $7.1 billion increase in market cap. That boosts Schwab's capitalization to $59.1 billion from $52 billion, for a 13.6% increase in the value of the company, and presumably its stock.

Here's another way to think about it, from Puglia at T. Rowe Price. If a company has a 40% tax rate, that means it has a 60% after-tax profit margin. If you lower the tax rate to 20%, that's a 33% boost in earnings. (The decline of 20 percentage points divided by 60% is 33%.)

"The change would be very favorable to companies that have a high tax rate," he says. "I don't think people are focusing on this as much as they should."

Bigger division of wealth?

Of course, it's tempting to write off the Trump tax cut as yet more benefits for corporate bigwigs while the little guy gets ignored. But that's not necessarily the case. Presumably, companies would invest much of the windfall, creating new jobs, and inventing new products and drugs.

“We are robbing ourselves when we tax these engines of wealth, jobs, innovation and progress,” says Meyer. “If [former Fed Chairman] Ben Bernanke thought it was a good idea to apply quantitative easing to engineer a wealth effect, a cut in corporate taxes is far more effective and tangible.”

Plus, if the tax cut boosts the stock market, that will reduce unfunded pension liabilities at governments across the country, potentially lowering the tax burden on individuals, says Neil Hennessy, chairman and chief investment officer of the Hennessy Funds. “If you truly want to take care of middle America, you want a lower corporate tax,” he says.

The fine print

There are a few qualifiers to this theory, though.

One is that fiscally conservative Republicans may well push hard for any cut in the corporate tax rate to be revenue neutral, because of worries about our nation’s $19 trillion in debt, which goes above $60 trillion if you include promises from Medicare and other entitlements. This suggests the elimination of corporate tax deductions to offset the lower tax rate.

“We don’t know what the tax structure will ultimately look like, but many deductions might be phased out,” says Puglia. So, theoretically, as many companies could be hurt as helped by Trump’s tax changes. That could make the whole thing a wash, in terms of how much it helps the economy.

The other problem is that while the S&P 500 could get a boost from the tax cut, it would theoretically be about 10.5%. That’s certainly nice. But it won’t solve the financial woes of Chicago or other profligate governments.

For the math geeks, here’s the logic behind my estimated 10.5% boost to the market, from a corporate tax cut to 20%.

Among S&P 500 companies, 441 of them broke out U.S. taxes paid in their most recent annual reports, according to screens run for me by S&P Global Market Intelligence. I cut out the rest of them for my calculation here, since we don’t know what they paid in domestic taxes.

My “S&P 441” paid $218.6 billion in U.S. taxes in 2015. I knock that down by 7% to account for state and local taxes, for an estimated federal tax paid of $203.3 billion. This number includes current year tax paid plus deferred tax. A cut in the tax rate to 20% implies a tax savings of about $87.1 billion. That’s because 20% divided by 35% times $203.3 billion suggests a new tax bill of $116.2 billion, for the roughly $87.1 billion in savings. (That’s $203.3 billion minus $116.2 billion.)

Multiply that $87.1 billion by the forward P/E of 22 for my “S&P 441” (that P/E comes from S&P Global Market Intelligence) and we get $1.9 trillion. Added to a $18.3 trillion market cap for the 441 stocks that are my subgroup of the S&P 500, and that’s a gain of about 10.5%.

Stocks that should benefit

Whatever happens to the market, it’s pretty clear there will be some big winners among companies — or those paying the highest tax rates. Finding the companies that benefit the most is not nearly as simple as running a screen for those that pay the highest tax rates, and then going out for a beer to celebrate. There are several pitfalls, as I learned when I did this for you. Here they are, in case you want to hunt for high tax paying companies on your own.

- First you have to eliminate the companies that pay stupid-high tax rates. In screens run for me by S&P Global Market Intelligence, over 100 companies paid tax rates of more than 60% last year — including Avon Products Inc. AVP, -0.72% which tops the list with a tax rate of 3,609%. Obviously, something unusual is going on with these companies that distorts their tax picture. You can spend hours drilling down on them to try to figure it all out. Or you can just make things easier and clean up your short list by cutting them out. That's what I did.

- Next, you have to drill down to see where companies pay taxes. Oil States International Inc. OIS, -2.96% looks like the perfect candidate to benefit from Trump tax cuts, since it pays a high tax rate of 43.9%, according to S&P Global Market Intelligence. That puts it right in the sweet spot to benefit from a tax cut — not too high but higher than most. However, it actually pays most of its taxes abroad. So, any Trump tax cut won't help much. (The word "international" in the company name, of course, was a helpful clue.)

The bottom line here is that if you want to do this on your own, be sure to check where companies pay taxes. You can find this in the annual report footnotes, typically about two-thirds of the way through the notes, which are at the bottom of the 10-K filing.

Here's another head fake. Companies such as Party City Holdco Inc. PRTY, +0.32% Rowan Cos. RDC, -2.13% and Wendy's Co. WEN, -0.90% look like they will gain a lot from the Trump tax cut, since they pay tax rates of around 40% or more. But their balance sheets reveal gobs of debt. This could be a problem because Trump and House Speaker Paul Ryan have suggested they may want to reduce tax deductions for interest, says Puglia. So while those three companies would gain from a tax cut, they might lose on the interest-rate deduction side of things.

The main takeaway

The best companies to look for are those that pay high tax rates in the upper-30% to lower-40% range. This means they're probably paying the full 35% federal tax. (The rest is state, local and foreign taxes.) Consider favoring companies that have little to no debt. And look for ones that do most of their business in the U.S. That means most of their tax is paid in the U.S., too, and not abroad where Trump can't change the tax rate.

"Look for simple companies that run simple businesses," says Brian Peery, portfolio manager at the Hennessy Funds. "Look for pure-play U.S. companies with tax rates in the 40% range. That is really where you are going to see some huge incremental benefits."

Here are several companies that stand to benefit the most from any Trump tax cuts because they pay high tax rates, they pay a lot of tax compared to their market cap, they have relatively low debt, and they pay most or all of their tax in the U.S. (For an extended list of companies that may benefit, please see more complete lists at my website.)

Asset managers

These companies not only typically pay high taxes and have low debt, they'll get a boost from any market jump from tax cuts, because they manage money. That will increase the fees they get based on the amount of money they manage.

Companies that rank high for taxes paid in this group include: Cohen & Steers Inc. CNS, -0.83% at 42.9%, WisdomTree Investments Inc. WETF, -1.41% at 41.6%, T. Rowe Price Group Inc TROW, -0.24% at 38.9%, Waddell & Reed Financial Inc. WDR, -0.34% at 38.5%, and the investment bank Houlihan Lokey Inc. HLI, -0.83% at 44.5%. Exchanges fit into this, too, including CME Group Inc. CME, -0.73% which pays a tax rate of 36.3%, and BATS Global Markets Inc. BATS, -0.32%at 40.7%.

Retailers

Lots of retailers and consumer companies come up with very high tax rates. They already stand to benefit because of rising wages, low unemployment and increasing consumer confidence. A tax cut would help them even more.

The ones in this group with lower debt levels and higher tax rates include Hershey HSY, -0.16% which has a 43.1% tax rate, Under Armour Inc. UA, -2.00% at 39.9%, Home Depot Inc. HD, -0.04% at 36.4%, CVS Health Corp. CVS, -0.47% at 39.3%, Lowe's Cos. LOW, -0.66% at 42.4%, TJX Cos. TJX, -1.06% at 37.7%, Best Buy Co. Inc. BBY, -0.44% at 38.4%, Advance Auto Parts Inc. AAP, -0.67% at 37.1%, Whole Foods Market Inc. WFM, +0.02% at 38.7%, Dick's Sporting Goods Inc. DKS, -0.74% at 37.8%, Tile Shop Holdings Inc. TTS, -0.95% at 41.4%, Chipotle Mexican Grill Inc. CMG, +0.20% 38.2%, and Monster Beverage Corp. MNST, -1.50% at 38.7%.

Airlines

Here, high-tax and low-debt companies include Southwest Airlines Co. LUV, -0.44% at 37.3%, Spirit Airlines Inc. SAVE, -0.75% at 36.9%, and SkyWest Inc. SKYW, +1.52% at 39.4%.

Small-cap companies

Lots of smaller companies stand to benefit because they have simpler businesses with fewer deductions and high tax rates since they can't afford expensive tax attorneys, says Bruce Bittles, chief investment strategist at Baird. So, Trump's tax cuts could help them a lot, and contribute to recent strength in this group.

Here, companies with relatively low debt levels and high tax rates levels include Pegasystems Inc. PEGA, -1.44% at 40%, Inovalon Holdings Inc. INOV, -3.64% at 42.4%, Semtech Corp. SMTC, -0.39% at 43.6%, Netgear Inc. NTGR, -1.05% at 43.2%, Taser International Inc. TASR, +2.84% at 43.6%, and Shutterstock Inc. SSTK, -1.75% at 43%.

Oh, the headaches

While a big tax cut could boost investor profits, it would not be all smooth sailing. A huge problem is that a big tax cut would mean new earnings and valuation numbers are incomparable with historical data. "This will make comparisons with prior years almost meaningless," says Meyer, at Bastiat Capital Funds.

At the time of publication, Michael Brush had no positions in any stocks mentioned in this column. Brush has suggested LUV and TASR in his stock newsletter Brush Up on Stocks. Brush is a Manhattan-based financial writer who has covered business for the New York Times and The Economist group, and he attended Columbia Business School in the Knight-Bagehot program.