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What Tax Cuts Mean for Investors

The stock market turned strongly positive after Donald Trump won the presidential election. To some extent, this can be attributed to expectations of a drastic cut in corporate taxes. Trump's tax reform also includes proposals to encourage the repatriation of foreign profits. Most US companies with foreign profits judged the corporate tax rate of 35% too punitive and made the rational decision to keep the funds abroad. In some cases, these foreign earnings were invested in US Treasuries, but this does not qualify them as repatriated earnings.

Judged by market capitalization, Apple is the largest company in the US with extensive operations abroad. Under Trump's Tax Reform Framework (published September 27, 2017), Apple's worldwide profits, most of them Ireland-based where the corporate tax rate is 12.5%, would be taxed at 20%, with a tax credit for foreign taxes paid. The objective of the new rules is to remove the incentive for companies to flee to tax havens. In addition, unremitted foreign earnings that have accumulated overseas under the old system will be treated as having been repatriated and won't be liable for a repatriation tax.

All things being equal, the corporate tax cut will save Apple $3.1 billion and add $0.60 per share to the company's fiscal 2018 earnings, even if pre-tax income registered no growth. At a valuation multiple of 18.1, a $3.1 billion tax saving translates into an approximately $55 billion impact on the company's market cap.

The levying of taxes on corporations destroys capital. The capital destruction is approximately equal to a company's tax burden times a company's price to earnings ratio. Washington takes $3.1 billion, and Apple shareholders suffer a $55 billion hit. A better way to raise revenues would be to exempt corporations from income tax, but then tax dividends and capital gains at a 25% rate with a deduction of only 50% on short-term trading losses. A one- to two- percent revenue tax on global revenues could be added to the equation. A revenue tax would eliminate the need for a corporate tax code and release the brain power of tax accountants for more productive endeavors. Capital allocations decisions should be based on cold logic rather than be distorted by tax code intrigue.

Financial statements are accompanied by hundreds of footnotes. It pays to understand what they all mean. For example, one of the footnotes in Apple's 2016 10K has a reference to a deferred tax liability described as

"Unremitted earnings of foreign subsidiaries," amounting to $31.4 billion. Under Trump's proposed tax reform, this liability is no longer valid. Think of it as debt forgiveness. Eliminating the liability equates to an increase in Apple's net book value (shareholders' equity) of $31.4 billion and, as the company's stock trades at a price-to-book-value of 6.1, it means $190 billion in market capitalization.

One should not conclude from this that if the tax reform proposals become law, that Apple's market cap would go up by $245 billion. Rather, we should understand that if Congress fails to meet our expectations, Apple's market value (and the market as a whole for that matter), could decline by approximately $245 billion. This is another way of saying that the increase in Apple's current market capitalization from $590 billion a year ago to the current $810 billion is almost entirely attributable to expectations of a tax cut and an elimination of the repatriation tax on foreign earnings.

On October 17, 2017, Treasury Secretary Steven Mnuchin warned that if tax relief was not enacted, "you're going to see a reversal of a significant amount of these gains." The above analysis confirms Mnuchin's fears. Enact, or DOW 18,000 here we come.

Why are governors and mayors not storming Washington on hands and knees begging for the lowest possible corporate tax? The public pension funds of state and local governments are apparently dealing with unfunded pension liabilities amounting to $2 trillion based on an average 7% compound return. Major tax relief would go a long way to deal with the problem of unfunded pension liabilities, not to mention the millions of Americans with retirement accounts heavily invested in the S&P 500 and other equities.

Corporations are the engines of growth, job creation and innovation. Corporate taxes only yielded $350 billion in revenue, or 9% of total expenditures in fiscal 2016. Apart from practicing fiscal discipline, Washington ought to raise revenues without resorting to the destruction of capital.

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