INVESTMENT STRATEGIES

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Tax Reform – Updated

What do we know now?

With the tax reform bill having now passed both houses of Congress awaiting President Trump's signature placing the bill into law, we now have what is the final bill. While most of the changes this bill engenders are "big picture" in nature or impact individual taxes, some things in the bill may affect investment strategies.

Tactics for 2017

Prepay state and local taxes: With the bill passing right at year end, and with changes taking place for the 2018 tax year, taxpayers have very little time to make any tax planning steps for 2017. On a personal level, investors may consider pre-paying their 2018 property tax, as they may achieve deductibility of this tax in 2017. However, the bill disallows deductibility of pre-paid state and local income taxes. Taxpayers also have to consider the alternative minimum tax (AMT) in this equation, as deductibility of these taxes is limited under the AMT. Your tax adviser can tell you whether this is an appropriate tactic.

Accelerate charitable giving: Taxpayers may also want to push forward their charitable giving into 2017. A slight drop in marginal tax rates and the increase in the standard deduction may make these deductions more valuable in the current year.

Take capital losses: The capital gains and qualified dividend tax rates will be largely unchanged under the new law. But with the slightly lower tax brackets and extended bracket size, capital losses may be worth more this year – although we suggest consulting your tax advisor for advice.

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Strategies for 2018 and beyond

Let's look at the impact of the tax law changes on investments and investment activity. The change in business tax rates may have more of an impact on investments. Under the final bill, corporate tax rates are sharply reduced, although certain adjustments and deductions will be limited or eliminated in the final bill. So the true reduction in rates will be much lower than what the difference between the current corporate tax rate of 35% and the new corporate tax rate of 21% might indicate. The current effective corporate tax rate after taking into account the various deductions and credits is in the mid-to-high 20% range, although tax rates vary widely among industries, with some (pharmaceuticals in particular) paying rates in the mid-teens, while others pay near or even above the 35% statutory rate.

Those industry sectors paying at particularly high tax rates appear most likely to be positively affected, with retail and energy two sectors that might see a significant impact. We note there are also other benefits for business, with such things as 100% expensing on certain capital equipment, which could further reduce tax expense in comparison to the prior method of depreciating such assets over time periods ranging from 5 years to 30 years.

Also under the new tax bill is a special, reduced tax rate for companies that repatriate assets and cash from overseas back to the United States. This lower tax rate is likely to induce some corporations and businesses to bring cash and other foreign-domiciled assets back to the United States. On the flip side, we note that a new limitation on interest expense deductions could hurt some debt-intensive businesses.

Who benefits?

Now knowing the particulars of the tax bill, the question remains, does the lower corporate tax expense benefit the bottom line (shareholders through higher earnings and dividends), go to employees (through higher wages), or go to customers (through less expensive products and services)? Our gut opinion is all three stakeholders would benefit. But, given the low cost of capital investors are currently requiring and strong competition, we would not be surprised to see the largest portion go to customers through lower selling prices. The additional capital flowing back into the country from repatriation is likely to also go to these three areas, although we see more of that going to shareholders through share buybacks and higher dividend payments.

We also note the tax rate for pass-through companies will be moved more in line with the number for corporate tax, compared to the current law which taxes such income at the individual rate. This is also likely to result in additional business investment, as well as higher income for the proprietors of such businesses, which could lead to additional economic activity as this income is plowed back into the economy through spending and/or investment.

Market effects

Overall, we consider this to be positive for both companies and the equity markets, and at least some of the reason for a spike in the markets over the past several weeks as it became more likely tax reform legislation would be passed. Having said that, we worry about "Buy the rumor and sell the news" action here, if investors decide to lock in some profits. Investors should be aware of the potential for this.

Another worry we have is that the significant increase in the markets over the past year has pushed up market multiples to levels well above the historic averages. Based on at the current estimate for 2018 earnings on the S&P 500 (a little over $134), we are trading at a multiple in excess of 20 times forward numbers. Estimates are likely to be $10-$20 higher on tax reform, with estimates now as high as $150-plus.

Even using these estimates (which we believe could be high, as we expect competition to result in some of the benefit to accrue to customers through lower prices), we are still trading at over 18 times forward earnings. We note this is solidly above the multiple prior to the 2008 market break, although under the 2000 market crash. We worry that, if investors are too optimistic on the benefits of the tax bill, and the numbers come in below expectations, these high valuation metrics could become an anchor around the market's neck. For individuals, there are changes on the tax rate front, although not to the degree of the business tax changes. The bill retains seven tax brackets, with each of the rates down very slightly and the size of each bracket increased a little. In general, this reduces the marginal tax rate for most taxpayers.

Other tax changes – and impacts

The personal exemption will be eliminated, but the standard deduction will be increased – going to $12,000 for individuals and $24,000 for married couples. This tends to hurt those who itemize deductions, while helping those who don't. Also, most itemized deductions will be eliminated, with the exception of mortgage interest (limited to $750,000 in debt), charitable contributions, and a limited deduction for property/state and local taxes ($10,000 limit). All other deductions would be eliminated, with the exception of the medical expense deduction, which will actually see a decline in the floor to that deduction to 7.5% for 2018 and 2019.

The alternative minimum tax (AMT) deduction is to be increased, while the level at which this deduction phases out will also be increased. This may take some of the sting out of the loss of the state tax deduction, as this deduction was often limited by the AMT anyway. There is also an increase in the child tax credit, which goes to $2,000 per child under the tax bill, with the phase out increased to $200,000/$400,000 (singles/couples) and the refundable portion going to $1,400 for 2018.

Among other changes would be a doubling of the estate tax deduction to $11.2 million, which will sunset in 2026. Also, investors will no longer be able to recharacterize traditional IRA or Roth contributions and/or conversions. Investors have been able to rescind their conversion of a traditional IRA to a Roth if the value of the conversion went down (thus, potentially lowering their tax liability for a future conversion). In addition, a number of fringe benefits that employers could offer to employees tax free are also being repealed.

In looking at the overall impact of the plan, its impact on businesses is much more pronounced than on the individual. While we expect most businesses will see a reduction in their tax liability, individuals will see a much more muted impact. In fact, a number of taxpayers (those with a lot of deductions) could see higher taxes, while others (large families, as an example) could see their taxes decline. In addition, with businesses likely to see lower taxes, business owners should see a positive impact here.

What should you do?

As far as what investors should do in light of these changes, we see little to do, other than to move to take realized losses in the current year – something we typically recommend anyway. Investors may also wish to make some changes to industry exposure, potentially moving into some of the sectors that might be positively affected by the tax law changes, while reducing exposure to those that might not see much of a benefit. The other area investors might look at are those with large levels of overseas assets. Those companies could provide positive benefits to shareholders, such as increased or special dividends or share buybacks, which could lead to positive stock price performance.

Additional information is available upon request.

Analyst Certification

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Investment Ratings

Buy: We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy:** We believe the stock is an above average holding in its sector, and expect solid total returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years. **Neutral:** We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise. **Underperform:** We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history. **2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks. **3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage. **4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	31	28%	13%	87%
Hold/Neutral	74	66%	9%	91%
Sell	7	6%	0%	100%

As of 6 December 2017

Other Disclosures

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