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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

A couple of months ago, I wrote about an exchange I had with a CPA at a conference where I was the presenter. This person was very much against any potential reduction in the corporate tax rate, apparently due to his personal perception of fairness, as opposed to professional misgivings. Let's just say we agreed to disagree.

Now, I don't believe we should eliminate corporate taxes, even if I were to benefit from it. Corporations avail themselves to the protection of laws, as well as the use of the nation's infrastructure. Simply put, you should chip in if you are using it, whatever it is. Don't bother arguing with me about double and triple taxation of the same dollar; I am not going to change my mind, even though I completely understand your argument.

Currently, the corporate tax rate in the United States is 35%. That is at the Federal levels, as the various states have their own. For instance, the top marginal corporate tax rate in California is 8.84%. That means a company headquartered in California could ultimately pay up to 43.84% tax on the profit it realizes in that state. Obviously, that is a lot of money, and I am more than certain plenty of companies out there go to great extremes to actually conduct business in various subsidiaries which are HQ'd or domiciled elsewhere.

But how does that compare?

When you combine both Federal & state, the United States has some of the highest corporate taxes in the entire world, and easily the highest of any, what I would call, competitive economy. Just the Federal tax rate of 35% is enough to put us in with the ranks of Cameroon, Angola, Pakistan, and Bangladesh. Seriously.

But that is the stated rate. What about the actual one? Well, according to the OECD, the 'weighted' effective corporate tax rate, including state, in the US is currently around 38.92%. The next highest in the OECD is France, at 34.43%. As for the entire, the mode is 25%, as is the median. The average of the 35 member group is 24.66%. As such, it would seem the US is high by around 13-14%, no matter how you slice it.

Let's think about that. 13-14% might not sound like much, but it can represent a fortune. Consider the following simplified example:

- US Company X has pre-tax income of $1 billion.
- After tax income is $610.8 million
- X has 500 million shares of common stock outstanding
- EPS is $1.2216
- X trades at a 15x Price/Earnings ratio, both trailing and forward
- Share price is $18.324
- Total market capitalization is $9.162 billion

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That is about the way it is currently. Now, consider what the numbers would be IF the US had the 'average' OECD corporate tax rate of 25%:

- US Company X has pre-tax income of $1 billion.
- After tax income is $750.0 million
- X has 500 million shares of common stock outstanding
- EPS is $1.50
- X trades at a 15x Price/Earnings ratio, both trailing and forward
- Share price is $22.50
- Total market capitalization is $11.250 billion

Clearly, the difference between the total market capitalization of Company X in the two examples is $2.088 billion. Think about that: the government 'foregoes' $139.2 million in taxes, and societal wealth increases by over $2 billion. By just about everyone's definition, besides Washington's, that is one helluva of a trade.

Make no bones about it. High corporate tax rates in the US, much higher than the global average, are keeping money out of your pocket….real money. If you assume all stocks behave in the same manner, you would see prices go up around 22.8%. Therefore, if you maintain a, say, 70% allocation to stocks in your 401K, voila, your investment portfolio just went up around 16% (.1596)

According to US News & World Report, the median 401K balance was around $18,127 at the end of 2014. Multiply that by .1596, and you come up with $2,893.07. There, that quantifies it. Simply having the OECD median and mode corporate tax rate of 25% could potentially benefit US 401K investors literally thousands of dollars a piece.

Let's consider another simplified example, this time from a manufacturer:

- Company X has a product it wants to produce for the US market.
- The company anticipates a pretax margin of 20% on sales of $1 billion. It has production facilities/subsidiaries in both southern Ontario and upstate New York, and the COGS are the same in either.
- According to the OECD, Canada's adjusted corporate tax rate is 26.70%, and, again, it is 38.92% in the US.

Where does it manufacture the product? Assuming all other things being equal, which they never truly are, the company would be wise to produce in southern Ontario and simply truck the stuff over the border.

Finally, consider the company who earns a substantial portion of its profits outside of the United States. Since the company doesn't want to repatriate the profits, and pay the potentially 38.92% tax less foreign tax paid on profits it

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earned elsewhere, it borrows the money in debt markets to make dividend payments. Why wouldn't it? After all, it gets to deduct its interest paid for tax purposes. As a result, the Treasury not only does NOT get any of the overseas profit, it also gets a reduction in domestic taxes paid due to the company borrowing.

According to the Tax Policy Center, here is how it works:

> Suppose, for example, a US-based multinational firm facing the 35 percent maximum corporate income tax rate earns $800 in profits on its Irish subsidiary (figure 1). The 12.5 percent Irish corporate tax reduces the after-tax profit to $700. Suppose the firm then repatriates $70 of this profit and reinvests the remaining $630 in its Irish operations. The firm must then pay US tax on a base of $80 (the $70 plus the $10 in Irish tax paid on that portion of its profits), or $28, but it claims a credit for the $10 Irish tax, leaving a net US tax of $18. If the firm has excess foreign tax credits from operations in high-tax countries, it can offset more (or possibly all) of the US tax due on its repatriated Irish profit. Meanwhile, deferral allows the remaining profit ($630) to grow abroad, free of US income tax until it is repatriated.

This is insane. The company increases its debt burden and reduces US taxes paid, all to pay domestic dividends on foreign profits that it doesn't want to repatriate due to the punitive, yes punitive, US tax code.

We can discuss fairness, tax dodging, and whatever until the cows come home. How does it benefit the US to have US multinationals keep their overseas profits overseas? In the example above, that $700 in profit sitting in some bank in Dublin ain't doing Joe Six-Pak any good.

This has a point.

I would argue the potential for a reduction in corporate tax rates is a primary, if not THE primary, reason the stock market has rallied since the election. However, no one really believes the Congress will be willing to take the rate all the way down to 15%, or lower. That would be very politically unpopular with constituents. Maybe 20% would fly, which would take the US to a shade under the OECD median when taking into account state taxes. As I type, I think 25% would probably be the odds on favorite.

Hey, we could discuss 15% or 20% or 25% until we are blue in the face. To me, that isn't the issue. Nope, it ain't. What IS the big issue is this: IF the Trump Administration AND the GOP Congress do NOT address lowering the Federal corporate tax rate in a somewhat meaningful way (10%≥) within a very short time from Inauguration Day, hours & days NOT weeks, the markets will lose this rally….and in a hurry. Period.

Trump's first 100 days HAVE to be about two things: lower/simplifying taxes AND lowering/reducing the regulatory burden. It can NOT be about building a wall with Mexico; repealing Obamacare out of spite, or going after the Clintons, in some form or fashion. Basically, if the Trump Administration starts out on economics, we could be in for a pleasant surprise.

If it starts out on politics, the markets could get pretty ugly, pretty quickly.