GENERALI INVESTMENTS

Focal Point

Trump's corporate tax plans: What is at stake?

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- Reforming corporate taxation is a top priority for both President Trump and the Republican majority in Congress. The proposals put forward include lowering the statutory rate (from 35% to 15%-20%), the end of the deduction for interest payments, the immediate amortization of investment expenditure and changes in the treatment of cross border income.
- Details of the reform will likely be finalized by the summer and it will become law no earlier than in Q3.
- Simpler and lighter corporate taxation would spur investment and employment, but may have unwanted side effects. The border adjustment of taxation may lead to higher inflation and a stronger US dollar. It may also clash with WTO rules, possibly triggering retaliation by trade partners.
- We estimate that a 10 pp reduction in the statutory tax rate will lead to an 8% boost to earnings. This could be partially offset by the likely US dollar appreciation and possibly higher political risk.

In the electoral campaign, a reform of corporate taxation ranked high among Donald Trump's election promises. His plans entailed a cut from 35% to 15% in the statutory rate on corporate income, the choice between fully deducting capital expenditure (capex) in the year it is undertaken or deducting interest expenses and a favorable (10%) rate on unrepatriated and future foreign earnings, regardless of where they are held.

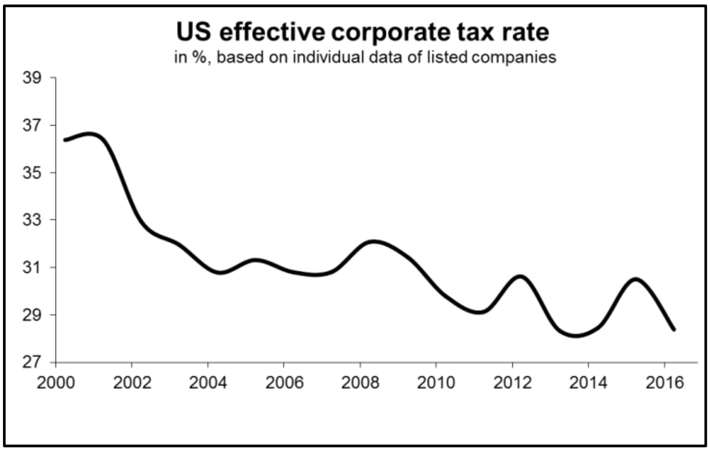
In some key aspects, the proposals resembled a reform plan by the Republican Party issued in June 2015, based on a 20% statutory rate. The tax base would exclude foreign sales, but no longer allow for deducting interest expenses and imported goods and services. Moreover capex would be fully expensed (i.e. completely deducted in the year it is undertaken).

Given the similarities between the two proposals it is likely that, over the course of the year, a corporate tax reform will be passed by the new Republican administration. It is clearly too early to foresee how the final law will look like, but these measures are likely to have important repercussions beyond corporate profitability and will affect the federal deficit, US dollar and global trade.

Lower tax rates is the easiest part

In terms of implementation, a cut in the statutory rate seems the easiest measure. It will have strong symbolic relevance and provide some boost to investment, even though empirical analyses do not offer a clear-cut estimate of its magnitude.

Investment expensing would remove the complex system of asset-specific depreciation rules, which is a source of capital misallocation and one of the factors behind the gap between the statutory and effective tax rate. Current rules allow firms to write off 70% of investment within two years after the purchase, so a move to full expensing would have a positive, but not huge, effect on capex.



Scrapping the deductibility of interest payments would help simplify compliance and, in some cases, reduce excessive leverage and distortion in the firms' capital structure.

However, a 20% tax rate would reduce federal receipts by around $1.8tn in ten years, and the net impact of the repeal of deduction on interest and full expensing is likely to affect negatively tax receipts. Therefore, given the pledge by made by the Republicans to deliver a revenue neutral reform, a broader tax base would be needed.

Border adjustment with large repercussions

A broader tax base would be achieved by replacing the current tax on profits with a destination-based tax on cash flows. Taxes would be raised on the difference between domestic revenues and expenditures on capital and labor. Revenues on foreign sales would not be taxed, whereas interest payments and the cost of imported goods would no longer be deductible.

The shift of the tax base to the country where the good is sold (rather than produced) would be a strong incentive for US firms to relocate production to the US. Moreover, jointly with a lower statutory tax rate, it would reduce firms' incentives for using transfer pricing to shift profits abroad.

The impact would be sizeable. Recent research estimates that around $370bn of US firms' profits (more than 15% of the total) are reported in the six largest tax havens, escaping US taxation. A full implementation of border adjustment would raise revenues by $1.2tn in 10 years, according to the Republican Party. The independent Tax Policy Center reckons that this alone would allow for a reduction of the statutory rate to 25%.

The macroeconomic impact would depend on how fast and thoroughly the border adjustment would be implemented. It would increase the costs of imports by 20% (the new statutory rate) while exports would be subsidized by the same amount. According to basic textbook economics, this shift in external prices would be offset by a sharp adjustment in the exchange rate, though. The currencies of US trade partners would weaken by 20% (implying a rise in the trade-weighted USD by 25%), restoring the pre-adjustment relative costs. At this level, the distortion in relative external prices from the tax would be completely offset, leaving the trade balance and after-tax profits of US firms equal to the case of no border adjustment.

A swift dollar appreciation by this amount is unlikely, though. First, trade accounts for only roughly 10% of global USD transactions. Second, many trade contracts are fixed in US dollar terms. So it would take time to see a border tax adjustment shift import and export prices in US$ terms, mitigating the economic case for an adjustment in the exchange rate. Third, many EMs (notably those with a large US$-denominated debt) will prevent a sharp depreciation of their currencies by FX intervention or higher policy rates to contain risks to their financial systems. Similarly, EMs with currency pegs or quasi-pegs to the US Dollar will find it hard to adapt to such a large dislocation in the fundamental value of their anchor currency.

If prices adjustment turns out more gradual, however, this will push up US inflation, likely requiring a more hawkish stance by the Fed to keep inflation expectations in check, underpinning the US dollar. Safe-haven flows into the US dollar (but also to the yen and euro) will increase on concerns about global trade and the dimmer outlook for EMs.

The upshot is that a full instantaneous 25% adjustment in the value of the US dollar is unlikely, but that the introduction of a border adjustment in the profit tax would still lead to a significant US dollar rally. This could easily be in the magnitude of 10% over the first quarters after its announcement, given that – based on correlations of the US dollar with yield differentials – investors have been so far reluctant to discount a border adjustment.

Implementation and timing

The full implementation of all these measures is not granted, however. Border adjustment appears to be by far the most difficult part to be put into law. First of all, the use of direct taxes to modify the terms of trade is very likely to clash with WTO rulings on export subsidies. Trade partners could retaliate by imposing countervailing duties on US exports or, in a move that would deeply harm global trade, adopt a similar tax system. Secondly, identifying the country where the sale occurs can be difficult for services and when exchanges between multinationals are considered. This would open the opportunity for loopholes. Overall the legal details could be cumbersome and President Trump has recently dubbed the idea as "too complicate". Finally border adjustment creates winners and losers (see below), and a fair amount of lobbying is to be expected while the legislation is drafted. All in, we give no more than a 30% probability to a full implementation of the border adjustment. It may take the simplified form of territorial taxation, whereby US-based firms would not be taxed for their operations abroad. This would greatly reduce the incentive to relocate domestically, though.

Changes in the taxation of capex and interest income have a large symbolic meaning and the Republican Party has staked a lot of political capital on them. Therefore a reduction in the statutory rate (probably to 22-25% in order to prevent a large revenue shortfall) and some incentives for investment are likely to be passed smoothly. If not matched by a meaningful broadening of the tax base, this would increase the budget deficit. The Congress' proposal to allow a repatriation of overseas cash at a low rate (which has a large chance of being passed and would raise around US$ 140bn) would provide some extra resources to smooth the impact on revenues.

Timewise, the discussion would start during the next weeks and a draft will be reedy no earlier than the end of March. The full tax reform could then become effective by October.

Implications for equities

Earnings of US companies would clearly benefit from the tax plans. Ignoring the effects from border adjustment and scrapping of deductibility of interest expenses, a 10pp cut in the statutory rate would, according to our estimates, decrease the effective tax rate for listed companies from 28.4% to 22.4%, leading to an overall 8% boost to profits. Assuming that tax cuts are approved before the end of 2017, the 8% profit increase would add to our previous estimates of 121$ per share for the current year (+3% yoy) which don't take into account the Trump's measures.

US: Sectoral impact of a 10pp reduction in the statutory tax rate

	Domestic income	Effective tax rate (%)		Net income
	% of the total	Current	10 pp reduction	% increase
US Market	60.3	28.4	22.4	8.4
Cons. discr.	79.5	33.1	25.2	11.9
Cons.	62.3	28.8	22.6	8.8
Energy	100	34.8	24.8	15.3
Financials	72.3	30.8	23.5	10.4
Health care	49.2	23.7	18.8	6.5
Industrials	71.3	26.9	19.8	9.8
IT	41.4	21.0	16.9	5.2
Materials	36.1	30.7	27.1	5.2
Telecom	100	33.8	23.8	15.1
Utilities	100	34.2	24.2	15.2

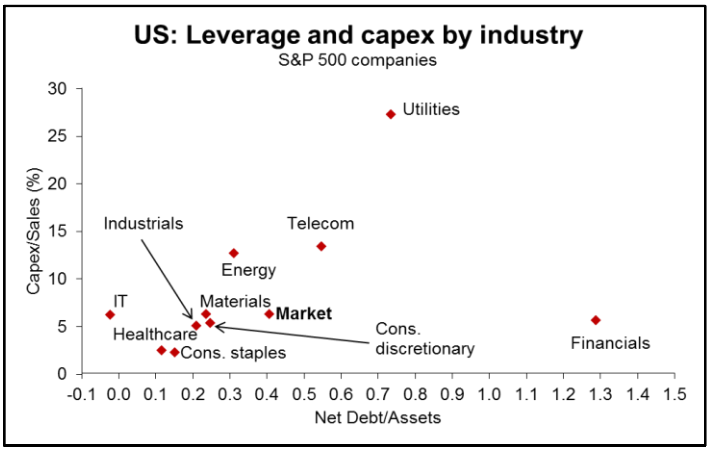
Industries with a larger share of domestic profits, like energy utilities and telecom would have the largest marginal increase in post-tax profits (nearly 15%, see table above). Financials and consumer discretionary should also see a good profit increase at around 10-11%. On the contrary, material, information technology (IT) and healthcare should experience a lower positive effect of around 5-6%.

These figures do not yet consider the effects of a border tax adjustment that may be included in the package.

Broadly speaking, border adjustment would severely harm sectors relying strongly on import from (mostly low-cost) countries and selling in domestic markets (e.g. apparel and large retailers). Moreover, sectors like electronics and automotive, which have a supply chain spanning several countries, would have to undergo a deep reorganization.

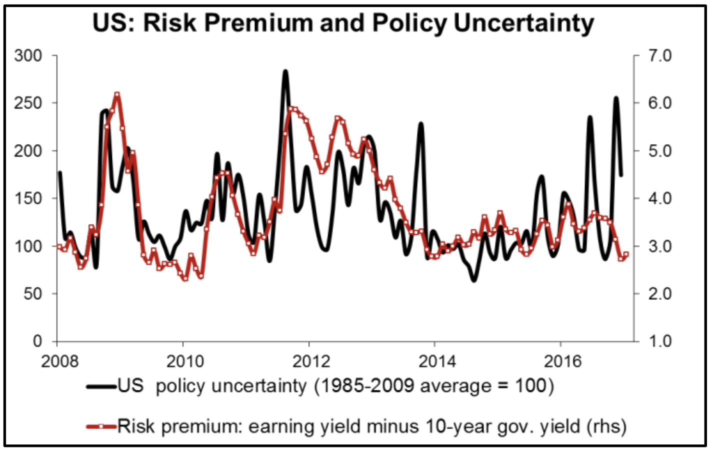
The impact of the full deductibility of investment should have a relatively small impact on earnings overall, but energy and utilities would likely benefit the most. Capex is also high for telecoms but the sector has also a very big annual depreciation charge and this would limit the advantage of the new fiscal legislation.

The elimination of the interest expense deductibility should be felt the most by utilities and telecom and less by IT and pharmaceutical firms. Finally, a reduced tax on foreign cash repatriation should have a smaller effect (less than 0.5% of annual profits). But it could contribute to sustain the buy-back yield at current levels (above 2% per year), even though other fiscal measures could for example lower the relative convenience of a high leverage.



A full assessment of the tax change has of course to take into account the impact of a stronger dollar and political uncertainty. We estimate that a 10% appreciation in the trade-weighted US dollar would shave nearly 3% from profits. Moreover, the confrontation between the Administration and the debt-conscious republican wing of Congress, as well as the international tensions brought about by the implementation of border adjustment, may raise economic uncertainty, which in the past has weighed on the equity risk premium and so on the S&P 500 price.

The upshot is that while Trump's tax plans are likely to visibly lift after-tax profits of US corporations, much of financial markets impacts will hinge on the still unclear details of the plan as well as the wider effects on the exchange rate and global risk sentiment.



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