ALTMAN
INVESTMENT MANAGEMENT

BRIEF INSIGHTS

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"In this world, nothing is certain except for death and taxes."
Benjamin Franklin

IN BRIEF: Implications of an Adjustment in the Corporate Tax for U.S. Equities

Fortunately, most of us have been able to avoid the first outcome for now, thanks to the latest Covid-19 vaccines. But many of us are not likely to avoid the forthcoming tax increases that might be needed to "pay for" all the latest rounds of fiscal stimulus. In the next several months, we anticipate reexamining our investment holdings in terms of their potential tax liability as the Congress begins to address the issues. Our relative value bias seems to have already discounted the multinational corporate exposure, and has pushed the average valuation discounts to an extreme. Is this foretelling a fait accompli? We have outlined our findings on the impact of Biden's tax proposals on U.S. multinational corporations below:

The Impact of Biden's Tax Proposals on U.S. Multinationals:

Much of President Joe Biden's tax plan is intended to offset his next big infrastructure package and attempts to address the GOP fiscal responsibility issue. The federal domestic statutory corporate tax rate was lowered from 35% to 21% as part of the 2017 Tax Cuts and Jobs Act (TCJA). Biden proposals are to partially reverse these TCJA changes by increasing the corporate tax rate to 28%. U.S. multinational companies could soon be paying more on their foreign tax payments too. Consider the following:

I - Competitive Disadvantage. Reversing the TCJA's tax rate cut could give the U.S. one of the highest corporate tax rates globally. Countries have shifted to corporate tax rates below 30% over time, according to the Tax Foundation in a 2020 study, with the U.S. following this trend at the end of 2017. The average corporate tax rate globally stood around 24%, according to our sources. At 21%, the U.S. rate fell competitively against the average for Europe (20%), Asia (20%), Oceana (24%), North America (26%), South America (28%), and Africa (29%). Most countries' rates range between 20% and 30%, according to the analysis; Biden's 28% rate would be near the top of that range. Increasingly, countries are trending toward further tax reductions in the coming years, according to the Tax Foundation.

II - Global Minimum Tax. A problem inherent in raising domestic tax rates is that U.S.-based multinationals are equipped with tax experts who are adept at finding ways of avoiding federal taxes by seeking tax havens elsewhere. The U.S. Secretary of the Treasury Janet Yellen has suggested a "global minimum tax". The concept, previously advocated by her predecessor Steven Mnuchin, isn't new, but it is gaining momentum. Yellen recently said that she believes she has the support of world leaders to implement it, according to the Wall Street Journal in early April.

The purpose of the global minimum tax, according to Yellen, is that it would allow the U.S. to be more "competitive" on an international tax basis. She also said that it is "about making sure that governments have stable tax systems that raise sufficient revenue to invest in essential public goods and respond to crises, and that all citizens fairly share the burden of financing government."

The Organization for Economic Cooperation and Development and G20 countries aim to reach consensus on a global minimum tax by mid-year, according to Reuters. "Since the talks are consensus based, countries are expected to go along with agreement no matter how unpalatable it may be for some low tax countries." The minimum tax, combined with new tax rules on cross-border digital services, is expected to contribute about $50 billion to $80 billion in corporate income tax revenues for governments.

Reuters also noted: "The global minimum tax rate would apply to companies' overseas profits. Therefore, if countries agree on a global minimum, governments could still set whatever local corporate tax rate they want. But if companies pay lower rates in a particular country, their home governments could move their taxes up to meet the agreed minimum rate, eliminating the advantage of shifting profits to a tax haven." The Biden administration would potentially deny exemptions for taxes paid to countries that don't agree to a minimum rate.

III - Global Intangible Low-Taxed Income. The Biden administration also would seek to double the Global Intangible Low-Taxed Income (GILTI) tax. Created under TCJA, the intent of the GILTI tax was to discourage U.S.-controlled foreign corporations from moving profits related to what might be characterized as easily moved assets, like intellectual property rights (copyrights, trademarks, and patents), to regions where local taxes are lower than U.S. rates. Companies with foreign profits mainly derived from intellectual property - such as those in the information technology sector - are more likely to have their income taxed as GILTI. But other sectors - like manufacturing - have been caught by GILTI as well, according to the Tax Foundation.

To better understand GILTI, it helps to first clarify how the current system of international taxation works. A May 2020 Tax Policy Center (TPC) report outlines: "All countries tax income earned by multinational corporations within their borders. The [US] also imposes a minimum tax on the income U.S.-based multinationals earn in low-tax foreign countries, with a "credit" for a portion of foreign income taxes paid. Most other countries exempt the income their multinationals get from foreign sources.

IV -Three Types of Taxation. The TCJA-created GILTI is one of the three major current types of taxation on U.S. multinationals' foreign-sourced earnings, the TPC briefing explained. Specifically, the three types are: (1) U.S. companies earning a "normal" return on assets - which is deemed to be 10% per year on the depreciated value of those assets - are exempt from U.S. corporate income tax; (2) GILTI is the profit over that "normal" return threshold. It is taxed annually at an effective rate of between 10.500% and 13.125%, but it can be higher in certain circumstances; and (3) Income from passive assets is taxed at the full corporate rate, with a credit for 100% of foreign income taxes paid on that income.

V - ***Unclear Path of Preferences.*** Complicating matters, Biden's tax plan would have GILTI calculated on a country-by-country basis, as opposed to via a single global calculation under TCJA, which was cited in a *WSJ* editorial this month. Under the TCJA, profits in some regions offset losses in others - serving to mitigate tax impacts stemming from the absence of loss carrybacks or carryforwards. Without getting too deep into the details, the Biden plan's country-by-country approach would sometimes lead to taxing profits that are a recoupment of earlier investments, economically speaking. This approach is also much more difficult and costly to administer. Even "tax-happy Europeans" have avoided this sort of tax calamity - and we believe the U.S. Congress would be hard pressed to do what the Europeans would not do.

In Summary:

We estimate that the impact of Biden's federal tax increase would reduce S&P 500 earnings per share by about 7%. But it remains unclear how increases in corporate taxes, personal income taxes or capital gains taxes might be packaged. As you know, the administration would likely have to pass any legislation through reconciliation, since it could not command a two-thirds majority in the Senate. While such tax increases could be included in a reconciliation bill, they will inevitably be subject to negotiations among the Democrats (we assume no Republicans would willingly sign off on an increase in taxes), even if there is widespread support from Democratic voters.

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