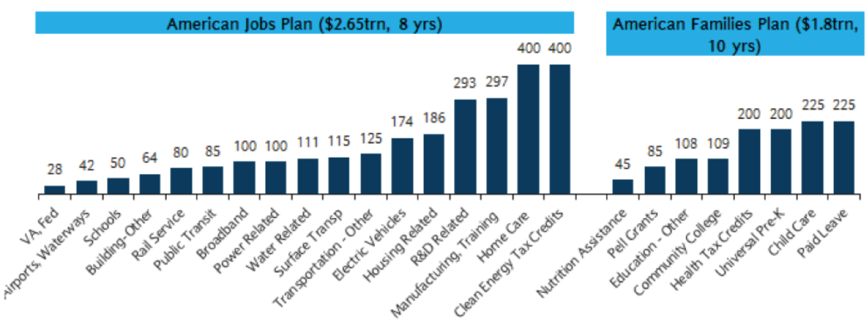
Tax Changes & Infrastructure Spending

The purpose of this write-up is to outline the likely impacts to corporate earnings and valuations under various tax policy change scenarios. To be sure, the ultimate content, timing and method of the contemplated policy changes under the American Jobs Plan (AJP) and the American Families Plan (AFP) remains highly uncertain. However, we believe that being prepared for a variety of potential outcomes will be key to managing volatility for the remainder of the year and leading up to the midterm elections in November 2022.

The American Jobs Plan (AJP) calls for $2.3 trillion in spending over the next 10 years. The key spending buckets in the proposal are: $558 billion for core infrastructure projects like transportation (i.e. highways and transit) and utilities (i.e. water and sewer); $374 billion for technology infrastructure which includes broadband and grid modernization; $480 billion for R&D and manufacturing incentives; and $500 billion to caregiving and workforce development. The American Families Plan (AFP) calls for $1 trillion in new spending and $800 billion in new tax credits. It includes $225 billion of funding for paid leave, a $200 billion program offering universal pre-kindergarten; $109 billion for tuition-free community college; and $85 billion to Pell Grants.



Source: Barclays Research

The two plans combined total more than $4 trillion in government spending, on top of the $1.9 trillion coronavirus relief bill passed at the outset of 2021. The administration's two proposals include tax increases that would pay for both plans in full over a 15-year period.

Historically, markets do not really begin to discount tax or regulatory changes until after they have officially been signed into law. Nonetheless, we think it is important to outline both 1) the possible short-term impacts to equity markets resulting from the mere threat of corporate and capital

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Rene J. Negron | Analyst

- Passage of any of the contemplated spending and tax proposals remain highly uncertain
- The content and timing of any the bills will ultimately depend on the ability to use the reconciliation process, and the political appetite for passing a bi-partisan bill
- Negotiations between Senate Republicans, Democrats, and the White House are ongoing and will likely result in a significantly "watered-down," or smaller version of the proposed bills, likely to be passed through reconciliation
- Research indicates that the proposed tax changes would decrease 2022 S&P 500 earnings by 8.6%. A compromise version of the bills would result in a more modest earnings decrease of 5.5%
- The industries that are likely to be the most affected are pharmaceuticals, semiconductors, and companies with significant overseas earnings
- An increase in the capital gains tax retroactively applied through mid-2021 would meaningfully soften the effect of market participants front-selling the tax change
- Changes to the international corporate taxation regime will depend on the speed of OECD negotiations for establishing a "global minimum tax"

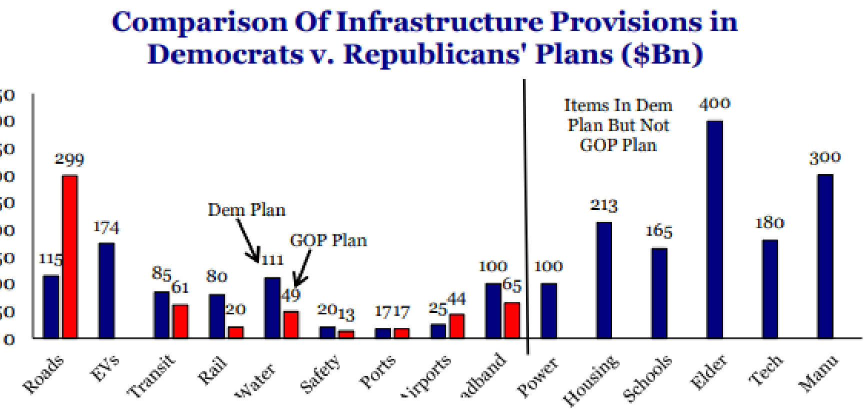
For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com gains tax increases, and 2) <u>real</u> effects to corporate earnings which would feed into equity prices in the longer-term.

Legislative Options

With the Senate split 50/50 until at least the midterm elections in November 2022, much of the current debate is focused on the legislative methods available to Congress for passing some version of the proposed spending plans. Central to the debate is the question of using the budget reconciliation process to pass legislation with a simple 51% majority. As a reminder, the Senate filibuster allows Senators to indefinitely delay bringing a resolution to a vote, effectively killing legislation if it does not have the minimum 60 votes to "break" the filibuster. Using a budget reconciliation process would allow Senate Democrats to circumvent a Republican filibuster, and pass legislation with a simple 51% majority.

Furthermore, within the budget reconciliation process, there are two possible approaches which could affect the timing of the proposals. Senate Democrats could either pass a 2022 budget resolution before October, or they could amend the 2021 budget resolution to permit a second reconciliation under the Congressional Budget Act of 1974. The Senate Parliamentarian has indicated that a revised 2021 budget resolution <u>can</u> contain reconciliation instructions, such that both alternatives are open for consideration. We believe that having both alternatives available increases the probability that at least some portion of the spending bills would get passed through the reconciliation process, as it gives democrats the flexibility of passing both bills through separate tracks.

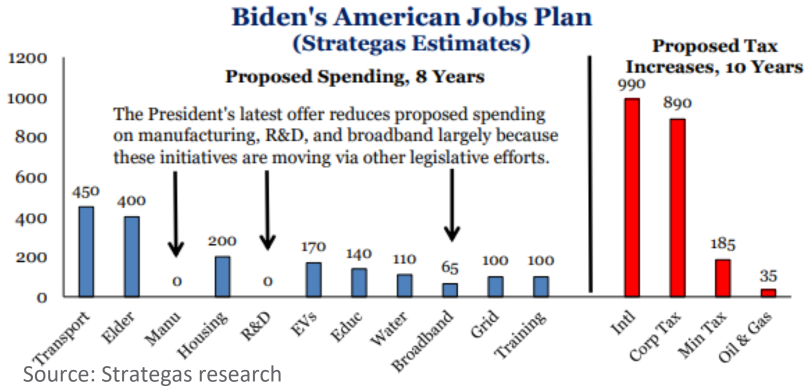
However, it is important to note that passing legislation through budget reconciliation has fairly strict limitations. The Congressional Budget Act permits using reconciliation for legislation that changes spending, revenues, and the federal debt limit. Additionally, the reconciliation process requires that the resolution not increase deficits beyond ten years. This is the primary reason why up until this point, the legislative focus has been on making sure the proposals are adequately funded in the longer term (e.g. to ensure that the initiatives would be eligible for passage through reconciliation).



Source: Strategas research

The three courses of action most likely to be pursued by Senate leaders are: 1) passing a bipartisan infrastructure plan in the $600 billion to $1 trillion range which only includes the core infrastructure initiatives (e.g. roads, electric vehicles, transit, rail, water, safety, ports, airports and broadband) and then passing the remaining initiatives through reconciliation; 2) passing one large reconciliation bill combining the AJP and AFP; or 3) passing two separate reconciliation bills for each proposal. There is of course also the possibility that no new legislation gets passed, or that the macroeconomic landscape turns negative thus decreasing public appetite for increased spending and taxes before the midterm elections.

On May 21, 2021 the White House announced a counter-proposal which would reduce spending in the AJP to $1.7 trillion. The ~$600 billion reduction would come from shifting funding for R&D and supply chain improvements to separate legislation currently being debated in Congress. Additionally, the counterproposal reduces the proposed investment in rural broadband from $100 billion to $65 billion, and reduces the proposed funding for "roads, bridges, and major infrastructure projects" from $159 billion to $120 billion. The White House / Senate Democrats and Republicans are more than $1 trillion apart on the size of their infrastructure proposals, which we believe is a good indicator that Democrats are likely to pursue passage through the reconciliation process, as opposed to a bi-partisan deal.



Source: Strategas research

Where the money is coming from

Below we outline the tax proposals which we believe would have the greatest effect on corporate earnings/valuations and investor decision-making. Though there are a broader set of tax changes beyond those we have listed here, we believe these are the ones that are likely to have the most meaningful impacts.

1. **Raising the statutory U.S. corporate tax rate to 28% from 21%**
   This is the corporate tax proposal which has received the most attention; perhaps because it is the one most readily understood by the majority of market participants. The consensus view is that ongoing negotiations will likely result in a more modest increase to a 25% corporate tax rate.

2. **Changes to the international taxation regime**
   This proposal is comprised of various changes which would effectively subject U.S. company foreign income to some form of incremental U.S. taxation.

   - Global Intangible Low Tax Income, or GILTI: the proposed change would increase the GILTI tax from 10.5% to 21%; tax foreign income on a country-by-country basis such that companies would be unable to use tax credits across low and high tax jurisdictions, and remove the policy which only taxes income derived from physical capital above a 10% return-on-capital threshold.
   - Replacing BEAT (Base Erosion and Anti-Abuse Act) with SHIELD: this proposal would make it more difficult for companies to use intra-company transactions to reduce tax liabilities across jurisdictions.

   Collectively, these changes effectively create a U.S. tax on a much greater share of overseas income generated by U.S. companies. As an example, if a U.S. company is taxed 5% by a local tax authority in an overseas jurisdiction, in most cases, that income would again be taxed an additional 16% (21% less 5%). Consequently, a key concern for the administration and Congressional lawmakers is that these international tax changes put American companies at a meaningful competitive disadvantage. This has prompted the administration to pursue a worldwide tax agreement at the OECD, which would essentially get certain countries to raise their taxes in order to create a globally consistent tax regime. Such an agreement would likely be less punitive to U.S. companies than the proposals under the Biden tax plan. However, timing is a key concern in pursuing the OECD agreement, as many lawmakers believe that an OECD deal would take longer to pass, and would therefore not be able to match the cadence of spending on the infrastructure initiatives.

3. **Minimum taxation on book income**

This proposal would establish a 15% minimum tax on corporate book income for companies with more than $2 billion in pretax earnings. Though an estimated 180 companies would meet the $2 billion threshold in the U.S., only 45 companies are below the 15% book income tax threshold and would therefore be affected.

A minimum tax on book income existed in the late 1980's following passage of the Tax Reform Act of 1986, but was ultimately repealed in 1989. At the time, the tax had the effect of encouraging companies to lower their book income (e.g. earnings that companies report to the public at large) in order to lower their tax bills. We believe that if this policy were reenacted, at least some of the largest U.S. companies would report lower taxable income for book purposes, which would result in modest corrections to equity valuations regardless of whether or not the company is actually paying more or less taxes.

4. **Raising capital gains tax from 20% to 39.6%**

This proposal would increase the capital gains tax and the tax on qualified dividends for households making over a $1 million to the top marginal income tax bracket of 39.6%, which would itself be increased from the current 37% rate. Including the Net Investment Income Tax (NIIT) of 3.8% would bring the total rate to 43.4%.

We believe that this provision is the one which presents the most meaningful short-term threat to equity markets, as it could cause a broad sell-off by investors attempting to lock-in a lower tax rate on their gains. Though the tax increase would likely take effect no later than January 1st, 2022, on prior occasions Congress has applied tax changes retroactively. We believe that a tax change retroactively applied through mid-2021 would meaningfully soften the effect of market participants front-selling anticipated tax changes.

Additionally, an analysis conducted by John Ricco at the Wharton School of Business found that raising the capital gains tax under a tax regime <u>with</u> a stepped-up basis at death (i.e. the current regime) would actually lower federal tax revenues by $33 billion between 2022 and 2031. With higher tax rates on capital gains, some investors would likely defer realizing gains indefinitely, given that their heirs can currently inherit equity without having to pay taxes on prior capital gains.

This is the primary reason why part of the administration's proposal is to do away with the stepped-up basis rule. The same analysis found that increasing the capital gains tax <u>and</u> getting rid of the stepped-up basis rule would increase tax revenues by $110 billion over 10 years. However, such a change would require meaningful investment in increased IRS enforcement, since investors would need to track the cost basis of every asset they own.

Which companies will be most affected?

According to Strategas research, the Biden plans (if enacted) would decrease 2022 S&P 500 earnings by 8.6%. In the more likely case that a compromise is reached and that corporate tax rates only go up to 25-26%, then Strategas believes that 2022 S&P 500 earnings would be 5.5% lower, growing 8% year-over-year instead of the current growth estimate of 14%.

Companies that are particularly exposed to adverse tax changes include:

- Companies with a significant share of overseas or intellectual property (IP)-related income. This would include healthcare (specifically pharmaceutical and biotech companies) and technology companies (especially semiconductor manufacturers). Pharma companies in particular also face the possible impact of adverse changes to drug pricing controls on their Medicare Part D sales as a part of the plan, while semiconductor companies should see some of their tax impacts offset by the $50 billion allocated to the industry within the infrastructure plan.
- Oil & gas companies also stand to lose given that the tax proposals remove tax credits and subsidies for most of the fossil-fuel industry (in line with the renewable energy and transportation goals included in the AJP). Chief among these is the removal of the intangible drilling credit which allows energy companies to expense their production costs.

A word of caution: headline rates ≠ effective rates

Lastly, we would like to note that effective tax rates on U.S. corporations have historically been significantly lower than the headline corporate tax rate. An analysis completed by New York University professor Aswath Damodaran indicates that independent of prevailing tax regimes, effective tax rates have trended downwards since WW2. As Damodaran notes, though the Tax Cuts and Jobs Act of 2017 decreased the corporate tax rate from 35% to 21%, effective tax rates decreased only 6.8%. Additionally, from 2017 to 2019 the dollar value of taxes paid actually increased 1.4%, and cash taxes increased by ~18.0%. The increase reflects both the amount of built-in discretion granted to U.S. corporations in deciding how much taxable income they want to report, as well as the broader macro-economic and industry factors which are ultimately more important to determining corporate tax bills. Investors should be careful to keep this in mind as they reevaluate equity valuations under a new tax regime.

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