Investing After A Christmas Tax Gift

I have been a vulture investor since the early 1990s. In 1998 I established Schultze Asset Management, an alternative investments firm. With a specialty in event-driven and distressed securities, we help institutional investors and family offices around the world invest in securities that offer uncorrelated returns. As I wrote in my book, The Art of Vulture Investing: Adventures in Distressed Securities Management (Wiley Finance, 2012), when companies become distressed, they go through restructurings. Investing in distressed securities is the practice of trying to find inefficiently priced securities in companies that are restructuring and going through significant change. People tend to shy away from distressed securities and bankruptcies. That’s what creates the opportunities we try to take advantage of. In my blog, I share insights and ideas that will appeal to investors looking for new investing opportunities that I believe will stand the test of time.

The author is a Forbes contributor. The opinions expressed are those of the writer.
In the early morning hours of December 20, 2017, the U.S. Congress passed the Tax Cuts and Jobs Act which President Trump is now expected to sign right before Christmas – thereby giving millions of Americans a tax cut for Christmas. This legislation is the most sweeping reform of U.S. tax laws in over 30 years and turns upside down many long-held tax planning strategies. The expected impact on investing is that certain industries and companies will benefit tremendously while others will be left behind at best. As a result, we expect that active investing strategies will begin to outperform in light of their managers’ ability to select among different investment alternatives.

From a corporate perspective, the primary changes from the new tax follow:

- A new maximum income tax rate of 21%, starting in 2018, with a repeal of the alternative minimum tax. This is one of the most significant changes since the prior rate was 35% and the new one will make U.S. companies much more competitive on the global front.

- A new one-time tax of 15.5% on cash (8% on illiquid investments) for accumulated offshore profits as well as a switch to a territorial taxation system for offshore operations. Importantly, the new law is also designed to limit the ability of U.S. companies to use transfer pricing to minimize U.S. taxes by moving intellectual property to offshore subsidiaries located in tax haven jurisdictions. This is the other most significant change from prior law which allowed an indefinite deferral of accumulated offshore profits and thereby incentivized U.S. companies to move capital outside of the U.S. and into countries such as Cayman Islands, Singapore, Ireland, Puerto Rico, and Switzerland.

- A new income tax rate cap of 25% for pass through entities (such as LP’s and LLC’s). However, this doesn’t apply to certain businesses (like hedge funds and other service businesses) and phases out for larger companies. Having said that, it will benefit manufacturers, real estate investment companies and certain other industries.

- A new limit on the deductibility of excess interest expense – set at 30% of EBITDA for several years and then switching to a fixed percentage of EBIT going forward. This will negatively impact overleveraged companies as well as the high yield new issuance market in general.

- A change to the carried interest rules which will require that an investment be held for three years to qualify for long-term capital gains tax treatment. This will continue to benefit private equity funds but only to the extent that they hold their investments for at least three years.
With respect to U.S. individuals, the primary changes from the new tax law are as follows:

- Lower individual income tax rates with fewer income brackets and substantially fewer deductions.
- An increase in the alternative minimum tax but no change to the top capital gains tax rate.
- Mortgage interest deduction will be capped at $1 MM for future home purchases.
- State and local income tax deductions will be capped.
- The estate tax exemption will double (from $5 to 10 million per individual).

In light of these significant new tax law changes, it’s important to consider the expected major corporate winners and losers from its impact. The winners from the new tax laws will be:

- Coal, oil and gas companies. Many of these firms were recently restructured and already trade at a significant discount to fair value as newly-reorganized equities. Going forward, they will clearly benefit from lower taxes, deregulation, and the expected uptick in the U.S. economy from tax reform.
- Banks are expected to continue benefiting from higher net interest income margins (due to higher interest rates from central bank tightening and reverse QE), deregulation, lower taxes (which help their customers and boost overall earnings), and a faster growing domestic economy due to tax reform.
- Unlevered mid-capitalization value stocks. Medium-sized companies that emphasize U.S. operations will benefit from the tax law changes since their corporate tax rates will drop significantly and thereby provide them with more cash flow.
- Medium-sized domestic infrastructure and manufacturing companies. These will benefit from lower taxes as well as the expected boost to U.S. GDP from tax reform.

The primary corporate losers from the new tax laws will be:

- Large/expensive technology companies. The companies will see a new one-time tax on their accumulated offshore profits as well as higher overall
income taxes. All other things equal, the tax reform legislation is a net negative for these companies.

- Large pharmaceutical companies. For the same reason as technology companies, pharmaceutical companies are expected to see lower earnings as a result of the new tax laws.

- Over-leveraged companies. These will be hurt by the new interest expense deduction limits. Moreover, over-leveraged companies with variable rate borrowings are expected to suffer from higher interest expense going forward as rates continue climbing as a result of Federal Reserve Bank interest rate hikes, reverse quantitative easing, and future inflation.

- Luxury home builders. These companies will likely see a slackening in demand due to the new caps on mortgage interest deductibility. However, the impact will not be as severe as it could have been under prior version of the tax bill.

With that in mind, for 2018 we expect that the tax reform legislation to help stimulate the U.S. economy and boost GDP growth by 2-3%. The most significant impact will come from the repatriation of accumulated offshore profits but the question then becomes how (business expansion or shareholder distributions) will this newly-repatriated cash be spent? The answer is that it doesn’t really matter since shareholder payouts help GDP growth too since they give shareholders additional cash to spend on additional consumption or new investments. For 2018, we now expect 2-4% GDP growth, lower unemployment (from its current 4% level), higher interest rates and inflation. In this environment, we therefore think it best to focus on value-oriented stocks but to not blindly throw money at passive investment strategies since there will be clear winners and losers from this major new tax legislation.

Merry Christmas!

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