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# Global CIO Outlook
# Sell the News on Tax Reform

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The usual and customary year-end tax planning by individuals and firms was complicated by the drama that was unfolding in Washington over the final shape of tax reform. But now, with the passage of the most sweeping overhaul of our tax system in over a generation, much of the uncertainty has been cleared up. Individuals and companies are already beginning to take stock of what it means to them, and taking action.

As an investment manager to a wide range of insurance, institutional, and retail clients, I see how this positioning is reflected in portfolio activity and individual behavior. What is playing out is consistent with that old investing adage of "buy the rumor and sell the news." Investors have been bullish about potential economic growth that will be driven by the new tax package, but now that the details and timing of the plan are known, they are starting to act in their self-interest.

As Arthur Laffer has always pointed out, the tax structure is nothing more than an economic incentive structure. We have seen how people and companies will change the volume, the location, the composition, and the timing of their income and expenses in response to changes in government policies. Now is no different.

Under the new law, the statutory tax rate for large C-corporations is cut from 35 percent to 21 percent, and the corporate alternative minimum tax is eliminated. These are very big gains for corporations.

Individuals are not so lucky in the new tax regime. The marginal tax rate is reduced a little bit for everyone except those in the lowest bracket, but key deductions have been eliminated, which could raise the adjusted gross income for certain individuals. This makes it all the more important for investors to consider ways to reduce their future taxable income.

There are two significant changes to individual deductions: First, eliminating the deductibility of mortgage interest expense on mortgages greater than $750,000. This will only apply to new mortgages and clearly impacts the wealthiest.

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Second, capping the combined state and local income tax (SALT) deduction and property tax deduction to $10,000. This is a big limitation in states where home values are high and/or state and local income taxes are high.

A couple of things that we see happening prior to year-end is that entities are generally planning to defer income if they will be taxed at a lower rate in the future, or prepay certain taxes that are applicable in 2018, including property taxes in high property tax states. (Readers should please consult a tax professional for applicability.)

Tax-loss harvesting has always been an important tool for income management. As we shift into a lower-tax regime in 2018, especially for corporations, we have been observing clients engaging in more aggressive tax-loss selling before lower tax rates kick in next year, because tax losses are more valuable in a higher-tax environment.

The new tax bill has had a perverse and unanticipated impact on corporate investor behavior related to distressed securities, including for life insurance companies. Corporate investors often carry securities at impaired values but choose not to realize the loss for varying reasons. Under the expiring tax regime, the value of a loss on an impaired security is the full impairment value times the corporate tax rate of 35 percent, but under the new regime it will only be worth the impairment value times the new corporate tax rate of 21 percent. With the loss worth more under the existing tax regime than under the new one, corporate investors are motivated to sell the impaired security now. The strong incentive to sell impaired securities before Jan. 1, 2018, has shifted some of the pricing power to the next available buyer. Recognizing this, a willing buyer can bid a slightly lower price on an already impaired security. Interestingly, in this case the buyer and the seller's interests are aligned because both want a lower price on the security. A lower price increases the value of the tax loss for the seller, and boosts the return for the buyer. These conditions are rarely in place, and we believe investors should take advantage of them before the year is over.

There may be some market impact as we see this activity take hold on a wider scale. While these tax-loss harvesting decisions could be made simply on the basis of cost relative to current market value, it makes sense to think more strategically, now and in the future.

Who are the best candidates for tax-loss harvesting in light of the new tax legislation? Investors may want to consider companies with significant debt burdens, such as those in the oil and gas industry, materials, and media (scan your portfolio for B-rated or CCC-rated companies). For these industries, the positive impact of a lower corporate tax rate will likely be negated by other provisions of the tax law.

Most importantly, higher-leveraged companies will be affected by the inability to deduct interest expense above 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA). By our calculations, several companies

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in the industries mentioned above deducted interest expense worth more than the new cap of 30 percent of EBITDA. Companies with interest expense already representing over 30 percent of EBITDA may reconsider raising additional debt, since the interest expense on new debt will not be deductible at all. This may shift financing to equity, potentially diluting existing shareholder value.

One might argue that these industries would benefit from immediate capital expensing, but there is questionable capacity for additional debt financing for the reasons specified above. We believe many of these companies cannot afford to finance new capital expenditures in the first place. In future research notes we will be diving deeper into these and other features of the tax bill that will have an impact on credit risk in the market.

In 1986 we saw how sweeping changes in the tax code had unintended consequences that devastated whole sectors of the economy, including real estate finance and the savings and loan industry. More recently we have seen how disparate corporate tax rates around the world incentivized domestic companies to offshore significant sections of their profit and loss statements. The tax bill that President Trump has signed into law will be no different. It will create winners and losers, and investors—and taxpayers—will need to be especially focused on the variety of ways in which this can play out as more of the details emerge.