InvestmentNews
The Leading News Source for Financial Advisers

If corporate tax rates were to drop

Some companies would benefit, but others would take a hit to earnings

By Robert N. Gordon

March 26, 2012

Lower corporate-tax rates may be coming. President Barack Obama has proposed that the maximum corporate-tax rate be cut to 28%, from 35%. Republican lawmakers suggest a lower maximum.

A lower corporate rate would produce many winners and losers, and because of the accounting for deferred tax assets and liabilities, we can identify some corporations that would be most affected.

First, some definitions.

Deferred tax assets are the value of deductions or credits used to reduce the tax on future taxable income. Deferred tax liabilities come from depreciation or unrealized appreciation that triggers a tax when an asset is sold.

A lower corporate rate has a negative effect on earnings for those with deferred tax assets but is favorable to the earnings of companies with deferred tax liabilities.

A recent study of the balance sheets of the Fortune 50 found that 18 of the companies had deferred tax assets totaling $82 billion, which would translate into a $16.8 billion decline in earnings for these companies if the maximum rate were to drop to 28%. Three giant banks account for 65% of that total.

If you think that the government might not want to do anything that adversely affects the banking industry or its capital base, then it would be logical to think that tax rates won't drop.

Consider American International Group Inc., which is still 70% owned by the U.S. government.

According to The Wall Street Journal, AIG recognized $17.7 billion in tax benefits in the fourth quarter last year, compared with about $1.6 billion in operating income from its insurance businesses and other units during the period. AIG's earnings from deferred tax assets would be worth $3.5 billion less under Mr. Obama's plan.

Among the other Fortune 50 companies studied, 31 have deferred tax liabilities totaling $202 billion, which means a lot of tax hanging over their heads.

If the maximum rate drops to 28%, from 35%, there will be $40 billion in earnings that immediately appears on these 31 companies' balance sheets. Berkshire Hathaway Inc. leads the pack at more than $7 billion in immediate earnings if the maximum corporate tax drops to 28%.

Closed-end funds that invest exclusively in master limited partnerships, commonly referred to as MLP ETFs, have deferred tax liabilities making up a large percentage of the balance sheet. MLP closed-end funds choose to pay a corporate level of tax as the cost of existing; a regular nontaxed mutual fund can't hold more than 25% of its assets in MLPs.

This extra layer of tax causes distortions in a few ways.

First and foremost, for every dollar that a fund receives from an MLP, just 65 cents is added to its per-share net asset value. MLPs make distributions that are treated as either fully taxable income (not a dividend) or a return of capital because of depreciation and other deductions.

An MLP ETF, as a tax-paying corporation, pays a 35-cent tax on the amount treated as ordinary income, leaving just 65 cents of every dollar for shareholders.

MLP distributions received by an MLP ETF that are a return of capital create deferred tax liabilities because the amounts depreciated earlier eventually are recaptured and taxable, just like Warren E. Buffet's deferred tax liabilities on Berkshire Hathaway Inc.'s low-cost-basis portfolio.

This deferred tax liability is deducted from NAV though the taxes aren't currently paid. The money continues to be invested in MLPs, and thus the NAVs are “understating” the value of the MLP portfolio owned by the exchange-traded fund.

It can be a big number. There are nine MLP ETFs in this position.

According to estimates from Ethan Bellamy, a senior analyst covering MLPs and U.S. royalty trusts at Robert W. Baird & Co. Inc., TYG, the oldest of these funds, had $10.44 of hidden NAV through its deferred tax liabilities as of year-end 2011; the stock trades for $41. TYY, trading at $28, has $6.32 of deferred tax liabilities per share (all calculated using a 35% tax rate).

If corporate tax rates go from 35% to 28%, the deferred tax liabilities immediately shrink by 20%, and the per-share NAV of the funds increases by 20 cents for every dollar of deferred tax liabilities.

Although we don't expect anything to happen with corporate-tax rates in the near term, it is better to analyze the possible impact if Washington surprises us.

Robert N. Gordon, who can be reached at bob@twenty-first.com, is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.