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The Tax Bill Contains Serious Flaws for Investors

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Details, Details

This article isn't a thriller, unless tax policy tickles your imagination. But it's an important investment topic, and I'll keep the discussion at a high level.

There's nothing wrong with Congress' *goals* for its tax-reform proposal, the Tax Cuts and Jobs Act. The bill seeks to end corporate America's incentive to stash assets overseas; to simplify the tax code; and to reduce the effect that tax policy plays on personal decisions, such as buying a home. All fine things. I also have no quarrel about which taxpayers Congress decided to reward, and which it will punish. Those were political decisions, and thus outside the scope of this column.

My concerns lie instead about the bill's details--a concern that does not yet seem to be shared by the lawmakers, who are racing to complete the bill before the holidays. To that end, Congress has bypassed the Treasury department, which customarily runs proposed legislation through a battery of financial tests and pushes back with pointed questions. (For an example, consider this Treasury report to President Reagan, on the 1986 tax-reform proposal.)

That haste has made waste. Consider, for example, the comments from a full-throated Republican--Robert Murray, who runs one of the country's largest coal-mining companies, and who earlier this year savaged Barack Obama and

Democrats as being "the greatest destroyers the United States of America has ever seen." The Senate's version of the bill, says Murray, would "wipe out everything that President Trump has done for coal." Should the bill pass, his company wouldn't "have enough cash flow to exist."

Mr. Murray never met an exaggeration that he could refuse. Nonetheless, the point remains: The Senate did not fully understand what it wrought. Fifty-two Senate Republicans, with no dissensions, would not have intentionally passed legislation that distressed a coal-mining CEO. They did so accidentally, because this bill is complex, and the math that normally amends the kinks hasn't been conducted.

Three investment-related items have struck my attention. I relate them in order of certainty, with the first having the clearest consequences (albeit also the smallest) and the third being the least predictable.

First In, First Out

As discussed in last week's column, the Senate proposes to eliminate investors' ability to choose which shares of a security to sell, so as minimize their current taxes. Investors no longer would be permitted to identify specific lots; for tax purposes, the first shares in would be the first shares out. (In some cases, the rule might stipulate average price.)

For the most part, this change wouldn't have big financial consequences. Most taxable securities are purchased all at once, rather than as a series of ongoing investments, and thus are unaffected by tax-lot regulations. In addition, if the investor eventually sells a security's entire position, the taxes are merely deferred rather than avoided.

However, one can certainly envision situations where this new requirement would hurt. Imagine an investor who buys 5,000 shares of a $10 stock for a taxable account, then five years later buys 1,000 shares of that same stock, when it has risen to $50. Two years later, he suffers a financial setback and needs to raise $30,000, with that stock now trading at $30. Under current rules, he could sell the entire second lot and owe no taxes (or a combination of the two lots, but never mind that). Under the Senate's proposal, he must sell shares from the first lot, which will lead to $20,000 of booked, taxable gains.

That is no fun. To avoid such problems, the savvy investor will game the system by opening separate brokerage accounts, so that he can pick and choose among those accounts when making security sales (the Senate's rule would only apply to securities within a given broker, not across several brokers). For the same reason, he will also buy smaller pieces of more funds, rather than bigger chunks of fewer funds.

A law that encourages investors to deconsolidate their accounts, and to own more securities rather than fewer. What, was Excel the bill's sponsor?

Small-Company 401(k)s

Sure enough, the next day after I publish a column suggesting how small-company 401(k) plans might be improved, I learned that the Senate bill jeopardizes them. Once again, the issue is unintended consequences. The Senate seeks to reward small-business owners by reducing their taxes, so that those who own pass-through companies will pay a lower federal income-tax rate than their employees. So far, so good, from the investment perspective.

However, cutting a business owner's tax bill decreases her incentive to sponsor a 401(k) plan. As pointed out in this memo from the American Retirement Association, under the Senate's proposal, a business owner who reaches the highest marginal tax rate would pay 27% on current income, and potentially 35% in deferred taxes on her 401(k) gains, assuming that the new legislation remains

intact until the time of her retirement withdrawals, and that she stays in the top tax bracket. She may decide against participating in a 401(k) plan.

If so, she is less likely to offer such a plan to her employees. Business owners sponsor company retirement plans for many reasons, many of which are unrelated to their personal finances, but their own investments certainly affect the decision. (I have seen enough pitches from 401(k) providers to small-business owners to attest personally to that statement.)

As Morningstar's Aron Szapiro says, "Unlike most other countries, the U.S. uses tax policy to motivate companies to offer their workers retirement plans. It is fine to change the mechanism; many observers argue, with good reason, that prompting actions through tax policies creates side effects, and is not the best path to take. But if tax policy is taken away, there needs to be a replacement."

Home Prices

This last item is clearly speculative--but is too important to be disregarded. The bill might depress housing prices enough to affect the stock market. There is no doubt that the tax-reform proposal will reduce home values. Both the House and Senate versions limit property-tax deductions to $10,000, and they each also chip away at mortgage deductions (albeit in different fashion). As the bills only take from real estate and do not give back, there is only one direction that home prices can take.

The question is, how large the decline? That we can only guess. The National Association of Realtors says the blow will be severe, at 10% to 30%. Well, it would say that. One should take the estimates of lobbying organizations with extreme caution. That projection in and of itself didn't much concern me. However, when Morningstar's Szapiro did his own work and arrived at a similar estimate, I got rattled. Aron doesn't wish to sell me anything, and he is adept with numbers.

So, a sharp drop in housing prices is possible. If that were to occur, I would expect the sort of knock-on effects that the U.S. suffered in 2007-08, when slumping home values weakened consumer demand, thus slowing the overall economy, injuring corporate profits and taking down stock prices. (Although one would hope, not so severely!) Others have argued the opposite, that stocks would rise because they would appear the better investment alternative to real estate. They could be correct. Suffice it to say that declining home prices would be disruptive.

Conclusion

As for the previous two items, the policy wonks can sort them out, if given the opportunity. I would expect anybody who thinks very hard about the subject to scrap the FIFO provision entirely (poorly conceived, no solution to investor subterfuge). As for small-company 401(k)s, Morningstar has its own suggestions, which I offered earlier this week. But there are other approaches. These problems are not insurmountable. But to do so, they must be mounted.

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