IS A TAX CUT COMING?

Now that it has become clear that the ongoing efforts to repeal and replace the Affordable Care Act have come to naught, Congress is about to tackle what has been billed as a massive revision of the tax code. The last major rewrite of IRS regulations was some three decades back, so it seems like high time for another review and updating. Where this is going is another question.

Based on the limited information currently available, it appears that the number of tax brackets will be reduced to three, ranging from 12% to 35%. Similarly, the tax rate for businesses would drop from 35% to 25% or lower. And income that flows through from small businesses such as those registered as LLCs or S Corporations would be taxed at 25% rather than at personal brackets, which are typically much higher. In addition, both the estate tax (levied against estates of $5.5 million or higher) and the alternative minimum tax would be eliminated.

No doubt, these changes would be appealing, but there's a flip side to the proposal. To offset the potential revenue loss from the rate reductions, loopholes in the tax code would be closed. The proposal calls for an end to certain deductions such as state and local taxes. What's also possible, though unlikely, is an end to the mortgage interest deduction, though one suspects that the opposition to this would be enormous, especially since it would deal a heavy blow to ongoing home sales.

It appears that most of the details for changes in the tax law will be debated and written by Congress, a process that certainly will be protracted.

Without going into much more detail, though, the question is what does it all mean? For one thing, although there's an appearance of broad tax relief, it turns out that the bulk of the prospective reductions is aimed at the more prosperous segment of the U.S. population. And for another, despite talk that the reduced revenue will be made up by closed loopholes and accelerated economic growth, it is more probable that there will be a considerable shortfall. In plain English, the national debt will be increased yet again, by $1.5 trillion or more.

As per the thought of more rapid growth, many economists expect that whatever gains will be achieved will be modest: perhaps another 0.25% in annual GNP growth. If that's on target, the net result may well be a disappointment. When taxes were cut during the Reagan years, the changes were enacted with the expectation that the gains provided for those at the upper end of the scale would trickle down to those at lower levels. It turned out, however, that not much trickled down.

This time around, it's no more likely that the trickle-down approach will be any more effective. What's more, if the extended wrangling over health care legislation proved to be difficult, what lies ahead for Congressional action on taxes will be even more of a challenge.

Aside from the nuts and bolts that may go into this major push, one wonders about the impact on investments. This can be viewed in at least two ways. The first, perhaps the more naïve, is that since reduced taxes will increase corporate net income, that should be reflected in a proportionate gain in stock prices. So if, for example, the Standard & Poor's

500 is currently at about 2500, a tax reduction allowing for earnings to rise by 8% would allow the S&P 500 to climb by 200 points. Maybe, though that's conjecture.

Another view would be that even though net income would rise, there would be no change in revenues or pretax income. Indeed, the only difference would be the reduced tax bite. Everything else would be the same, except that the additional net income available might help boost future growth.

Given this perspective and the fact that the U.S. markets are currently being valued toward the upper end of their historic range, one would be well-advised to view the prospective tax rate with a more cautious eye. Even if these changes come to pass, it seems overly optimistic, if not risky, to bid up prices increasingly closer to what would be considered perfection levels, leaving little or no room for the likelihood that some event or events will disrupt growth along the way. Indeed, the U.S. markets have continued to climb steadily, albeit at a moderate pace, seemingly indifferent to the possibility of an interim correction, geopolitical upheaval (North Korea or Iran) or some monkey wrench messing up what little progress might be made in the D.C. beltway.

Yes, the U.S. economy continues to expand at a moderate rate, but a more reasonable view would be to lower one's sights and be better prepared for the kinds of interim developments that always come along. While doing so, it would be a good idea to look abroad for investments. International developed markets are selling at a one-third discount to the U.S. markets. Emerging markets are selling at a 50% discount to U.S. markets. Greater discounts usually mean greater potential.

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