The Light

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Tax Reform Impact on Markets

By Tim Rowsey, CPA, Investment Advisor Rep.

One of the major initiatives that has been discussed recently is the potential for significant reform of the United States tax code. We want to explore what the possible implications of such reform might be on the equity markets.

When it comes to tax reform, there are three major areas that are being considered. The first area is corporate tax reform. Currently the top corporate tax rate is 35%. With tax breaks and deductions, the average company pays about a 22% rate. There are several corporate tax rate cut proposals. The House plan would reduce the top corporate tax rate down to 20%. The president's team proposes a drop to 15%. With the value of stocks heavily tied to the profitability of a company, tax reduction adds directly to a company's profitability. Some analysts have estimated that a 15% cut in corporate tax rates could drive stock prices up by 20% and a 20% tax cut could increase stock values by closer to 30%. Interestingly enough, some of these increases may already be partially included in current stock valuations. On March 1st after President Trump talked about "significant" tax relief the markets increased by more than 1.5%.

Some individual companies would benefit significantly from a reduction in federal tax rates. Below is a list of 10 companies that have a significant tax rate based on a recent report by JPMorgan. These are five-year effective tax rates:

Altria Group (MO), Tax rate: 35.2%
AutoNation (AN), Tax Rate: 38.4%

(continued on page 2)

Individual Income Tax - A Brief History

By Tim Rowsey, CPA, Investment Advisor Rep.

As the April 18th tax deadline approaches, we thought it might be interesting to take a look back at individual income taxation in the United States and how we got to where we are today. Our history as a country is at least partially based on rebellion against excessive taxation. For that reason it is not surprising that for more than half of our country's history there was no income tax for individuals.

Income tax was imposed for a short period of time during the Civil war and later in the 1890's. It wasn't until 1913, however, that the first income tax for individuals was permanently put into place. Prior to this time there was some debate on the constitutional authority of the federal government to levy an income tax. The 16th Amendment to the Constitution granted the Federal government the ability to tax income. Initially the rate was 1% on income over $3,000 and up to $20,000 with a maximum rate of 7% on income over $500,000. If those numbers were to be adjusted for inflation the 1% rate would apply to the first $460,000 of income and the 7% bracket would not apply until earnings hit over $11 million!

Over the next 25 years there were moderate adjustments to the system until the Internal Revenue Code of 1939 was put into place. In order to help finance World War I the top tax rate was temporarily increased to 77% on income over $1,000,000. This was quickly reduced after the war was over. During the Great Depression the top marginal rate again increased, topping out at 63%.

Congress introduced the idea of payroll withholding and quarterly tax payments during World War II. Also at this time Franklin Roosevelt proposed a tax rate of 100% on

(continued on page 3)

Reform (continued from page 1)

CVS Health (CVS), Tax Rate: 39.1%
CSX (CSX), Tax Rate: 36.8%
Discover Financial Services (DFS), Tax rate: 36.8%
Dollar General (DG), Tax rate: 39.1%
J.B. Hunt Transport (JBHT), Tax rate: 38.2%
Kohl's (KSS), Tax rate: 36.5%
Public Service Enterprise (PEG), Tax rate: 37.3%
Republic Services (RSG), Tax rate: 34.6%

For these companies, a reduction in their tax rate to 15% or even 20% would move a significant amount of profit to their bottom line and would impact their value.

The second type of tax reform that is being considered is individual tax reform. Currently both the House GOP plan and President Trump's proposal would have three tax brackets with rates at 12%, 25% and 33%. This compares with the current law offering rates of 12%, 15%, 25%, 28%, 33%, 39% and 39.6%. While the number of brackets would be smaller and effectively simpler, the impact on individuals at various income levels would be mixed. Some taxpayers would find themselves paying more tax, while others would pay less. This only considers the impact of the ordinary income tax rates.

Another potential change for individuals would be in the treatment of capital gains. Currently there are three capital gains rates depending on the regular income tax rate of the taxpayer. These rates are 0%, 15%, and 20%. President Trump's proposal would leave these rates intact, but would eliminate the 3.8% Medicare surtax on net investment income. Under the House GOP proposal, capital gains rates would exclude 50% of the gain, effectively making the rates half of proposed ordinary income rates. These would then become 6%, 12.5%, and 16.5%. This could be a significant boon to investors, depending on their tax bracket.

The last type of tax reform that is being considered is a "tax holiday." One of President Trump's proposals is to create a "tax holiday" that would allow American companies to bring back profit that was generated overseas at a low rate back into the United States. If this plan were in place it might tax this income at a one-time 10% rate compared to the current maximum 35%

corporate rate. Money brought back into the U.S. would have the potential to be used for further investment by the business in the U.S.

Three major U.S. companies have significant overseas cash that would be impacted by this type of plan. Apple (APPL) currently has over $216 billion in overseas cash. If there were to be a 10% tax on bringing this money back into the U.S., Apple would potentially add over $194 billion into their U.S. cash holdings while only paying $21 billion in tax compared to the $75 billion they would pay under current tax law. This $54 billion of savings spread out over a little more than 5 billion Apple shares would amount to more than a $10 per share increase in value.

A similar analysis on General Electric (GE) would show about a $1.25 per share benefit of a tax holiday with a potential increase of about 4% in GE's price just based on this analysis. Microsoft (MSFT) is the third major company that would also benefit from this plan. It has over $109 billion held overseas and the potential tax savings on repatriating these funds at a lower tax rate would amount to about a 5% premium on Microsoft's current price.

While no tax reform is certain, there are certainly changes under consideration that could have a significantly positive impact on the markets in the coming year. Watch with interest as tax reform moves to the forefront of legislation. It could have a significant impact on your investments. ■

History (continued from page 1)

all income over $25,000. This never became law. For several years leading up to 1951 the highest tax rate for individuals was 91%.

There was a major revision in rules when the Internal Revenue Code of 1954 became law. It contained many complex tax deductions and shelters and many high income individuals paid little or no taxes. In 1969 the Treasury Secretary informed Congress that 155 taxpayers with income over $200,000 had paid no income tax. This caused such a public outcry that Congress enacted an “add-on” tax that eventually became our modern alternative minimum tax. While originally intended to make higher income taxpayers pay their share of taxes, this tax now affects over 4 million taxpayers each year (many of whom would not consider themselves to be high income earners).

Over the years the tax code continued to increase in complexity and more and more loop holes and deductions were added. In 1986 the Tax Reform act of 1986 eliminated a significant number of deductions and greatly simplified the tax code. It dropped the highest tax rate of 50% down to 28% on ordinary income but brought capital gains up to the same maximum 28% rate. This act also consolidated what had been fifteen different income tax rates into four tax brackets.

Since 1986 there have been various tax changes which have moved the top rate in the range of 31% up to 39.6%. Currently the top marginal rate for a married couple is 39.6% on income over $466,950. Over time additional tax breaks and deductions have made the tax code more and more complex.

It is interesting to note that major tax reform happened in 1954 and then again in 1986 with 32 years between these major tax law changes. It has now been 31 years since the significant tax reform that was done during the Regan administration. It seems as though over the years the tax law grows more complex and cumbersome until there is a desire to do a major overhaul of the entire system. While tax reform is far from certain, the increasing complexity of the law and the frustration of many Americans may help reform to happen. This may be the once every generation year for tax reform. ■

Market Recap

How the major indices performed in the 1st Quarter 2017

DOW JONES INDUSTRIAL AVERAGE
1st Quarter return 4.6% YTD return 4.6%

S & P 500 COMPOSITE
1st Quarter return 5.5% YTD return 5.5%

RUSSELL 2000
1st Quarter return 2.1% YTD return 2.1%

BARCLAYS AGGREGATE BOND
1st Quarter return 0.8% YTD return 0.8%

Market Update

By Tim Rowsey, CPA
Investment Advisor Rep.

The first quarter of 2017 was a good one for equities.
Equities showed consistent growth in the first quarter across the board. The Dow Jones Industrial Average increased 4.6% for the quarter. For the Dow, this quarter was unusually calm in the midst of growth. There were 15 days in the first quarter where the Dow changed by less than 0.1%. This lack of volatility is extremely unusual. The S & P 500 was also up and gained 3.4% for the quarter. Small cap stocks as represented by the Russell 2000 had the smallest growth with a 2.1% gain for the quarter.

Bonds showed a small increase for the quarter.
The Barclays aggregate Bond index grew by 0.8% for the quarter. The bond market had dropped significantly after the election, partly in response to a Trump presidency and uncertainty regarding future Fed actions. The Fed did increase rates an additional 0.25% in March in a widely anticipated move. Additional increases are expected in 2017.

Potential tax reform and other regulatory changes may move the markets.
The failure of Congress to act on potential repeal of Obamacare temporarily slowed the markets growth as investors grew concerned about the ability of Congress to move ahead on their legislative agenda. The primary driver of future market growth may be tax reform. Questions remain about the ability of this Congress to act, however, there is movement toward some potential reform. If this happens there could be significant additional growth in the market. ■

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