QUESTIONS & ANSWERS

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THE NEW TAX LAW

Implications for Institutional Investors

F·E·G investment advisors

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President Trump signed a $1.5 trillion tax bill on December 22, 2017, officially making it the most sweeping tax law overhaul since 1986. The speed and manner by which it was passed left many lingering questions among individuals and organizations.

In an attempt to aid institutional investors, FEG has developed a series of Questions & Answers regarding the new law and its potential strategic impacts on the non-profit landscape, and some considerations unique to various non-profit market segments.

While not a comprehensive review of the new law, this discussion should provide chief investment officers (CIOs), chief financial officers (CFOs), staff, committee, and board members high-level points to consider as they navigate 2018.

INVESTING AND MARKET CONSIDERATIONS

Does the new tax law impact FEG's investment outlook for 2018 and beyond?

Importantly, the new law will take effect right away—it frontloads all of the tax cuts immediately into 2018. Markets reacted favorably when it became clear a tax reform plan was going to pass, suggesting some of the effect has already been priced into the market.

We also expect, however, there could be follow-on stock market support through share buybacks when companies find themselves with more cash either due to the lower tax rate itself and/or when profits currently held overseas are repatriated.

Although some resulting capital investment and/or increase in dividends may occur, a large percentage of the after-tax cash may be used for stock buybacks, as was the case in 2004.

It should be noted, the Center on Budget and Policy Priorities concluded the 2004 tax holiday did not produce the promised economic benefits because companies mostly bought back stock instead of investing to grow their businesses.[1]

Despite claims from President Trump and Treasury Secretary Mnuchin that the tax bill will provide a sustainable and significant boost to economic growth, most private sector economists expect a more modest impact. In the words of one economist, the bill is more "carbs than protein," and will provide a near-term boost to economic growth but not serve as a catalyst for a new paradigm for growth.[2]

Does the new tax law create any specific opportunities from an investing perspective?

As mentioned above, the contribution to economic growth and corporate earnings that the tax law is expected to provide may enhance stock market performance in the U.S., which also could support stock market performance overseas. Repatriation could also provide some additional support for the U.S. dollar.

What risks should institutional investors consider in light of the new tax law?

Jumpstarting economic growth through deficit expansion could lead to periods of unexpectedly high inflation. If that were to occur, the Federal Reserve would likely raise interest rates at a faster pace than currently expected, which could have negative implications for fixed-income and other interest-rate-sensitive securities. Higher rates might lead to a strengthening of the U.S. dollar placing downward pressure on unhedged international investments.

[1] Money.CNN.com. December 3, 2017. Matt Egan and Danielle Wiener-Bronner. "The real reason Wall Street is euphoric over the tax plan"

[2] U.S. News & World Report. December 21, 2017. Dan Kern. "How the Tax Plan Affects Investments." https://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/articles/2017-12-21/how-the-tax-plan-affects-investments

NON-PROFITS

What are the biggest potential impacts that concern non-profits?

Entering 2018, non-profits of all stripes are facing a different giving landscape. The new law basically doubled the standard deduction to $24,000 for couples and $12,000 for individuals and increased the estate tax exemption to $22 million for couples and $11 million for individuals.

Given the standard deduction increase, the Association of Fundraising Professionals (AFP) anticipate the number of itemizers to decrease by about 30 million, driving a not-insignificant fear within the industry of donations slowing. According to the Giving USA estimates, about 82% of individual giving comes from itemizers, which could equate to an annual loss in giving between $12 billion and $20 billion[3] or between 4% - 7% of the $282 billion[4] that U.S. charities garnered last year.

The potential decline is a lot for non-profits to bear. Are there other potential impacts?

Yes. The new tax law is expected to increase the national deficit by approximately $1.5 trillion over 10 years, which may spur further spending cuts in the federal budget that would likely trickle down to the state level.

Because about a third of state budgets are tied to federal dollars, any federal cuts may lead to state cuts which could negatively impact social programs.

In other words, the need for non-profit programs may become even greater if funding shrinks.

Are there other provisions that may impact my non-profit?

Larger non-profits should be aware that the new tax law imposes a 21% excise tax on compensation greater than $1 million paid by tax-exempt organizations to the five highest compensated employees. This provision includes so-called “parachute payments,” or money paid out when top non-profit executives or college presidents leave an institution.

NON-PROFITS OF ALL STRIPES ARE FACING A DIFFERENT GIVING LANDSCAPE.

THE DECREASE IN ITEMIZERS COULD LEAD TO AN ANNUAL LOSS IN GIVING OF BETWEEN $12 BILLION AND $20 BILLION.

[3] The NonProfit Times. November 2, 2017. Andy Segedin and Mark Hrywna. “Tax Changes Impact Philanthropy, Revenue Generation.” http://www.thenonprofittimes.com/news-articles/tax-changes-impact-philanthropy-revenue-generation/

[4] ABC News. December 28, 2017. Marcy Gordon. “Charity donations likely to drop next year due to tax law.” http://abcnews.go.com/Politics/wireStory/charity-jolt-tax-law-due-drop-year-52022300

HIGHER EDUCATION

I am employed by a four-year higher education institution. Are there any provisions specific to higher education of which I need to be aware as it relates to my organization's endowment?

The new tax law levies a 1.4% endowment tax that only applies to private colleges and universities with 500 or more students, and whose endowment assets have a fair market value of at least $500,000 per full-time student. According to the National Association of Independent Colleges and Universities (NAICU), there are 35 colleges and universities immediately impacted by the tax.[5] The list includes prominent universities such as Harvard, Yale, Princeton, and Stanford, but also many smaller institutions with endowments which are large relative to their student populations.

However, given the fair market value of $500,000 per full-time student is not adjusted for inflation going forward, in time, other schools may be added to the impacted list. As an example, Northwestern University's $9.8 billion endowment will remain untaxed in the near term because its fair market value is roughly $480,000 per student.[6]

Only time will tell if the tax is expanded to reach public universities or if the $500,000 per full-time student threshold is adjusted.

Additionally, there are some other, lesser-known provisions[7] such as:

- The elimination of the 80% charitable deduction for amounts paid for the right to purchase tickets for athletic events.
- Repeal of the exclusion from income for interest on advance refunding bonds, a tool sometimes used by universities to help finance capital funding projects.

These items that may have negatively impacted universities did not make it into the final bill and will not change:

- Graduate tuition waivers will continue to be waived from taxable income.
- Taxpayers can continue to deduct interest on qualified education loans.

[5] Inside Higher Ed. December 18, 2017. Andrew Kreighbaum. "Final GOP Deal Would Tax Large Endowments." https://www.insidehighered.com/news/2017/12/18/large-endowments-would-be-taxed-under-final-gop-tax-plan

[6] The Daily Northwestern. December 28, 2017. Alan Perez. "Republican tax bill spares Northwestern's $9.8 billion endowment." https://dailynorthwestern.com/2017/12/28/campus/top-campus/republican-tax-bill-spares-northwesterns-9-8-billion-endowment/

[7] Duke Today. December 19, 2017. Geoffrey Mock. "What's In the New Tax Bill Concerning Higher Education." https://today.duke.edu/2017/12/whats-new-tax-bill-concerning-higher-education

HEALTHCARE

I work for a non-profit in the Healthcare industry. Are there any provisions specific to my organization?

For Healthcare organizations, the new tax law is less about industry-specific provisions, and more about potential downstream impacts of the law.

The new law eliminates the penalty associated with the Affordable Care Act's individual mandate, which according to the Congressional Budget Office (CBO) could impact as many as 13 million people, leading them to lose or abandon coverage.[8]

The loss of insurance coverage could result in shrinking the total revenue pie available across the Healthcare ecosystem.

THE POTENTIAL FOR 13 MILLION AMERICANS TO EXIT HEALTH INSURANCE MARKETS COULD RESULT IN SHRINKING THE TOTAL REVENUE PIE AVAILABLE ACROSS THE HEALTHCARE ECOSYSTEM.

[8] Harvard Business Review. December 19, 2017. David Blumenthal. "How the New U.S. Tax Plan Will Affect Health Care." https://hbr.org/2017/12/how-the-new-u-s-tax-plan-will-affect-health-care

INDEPENDENT SCHOOLS

I am employed by an independent school. Are there any provisions specific to education of which I need to be aware?

The final language in the tax law omits some provisions that concerned independent schools, preserving current law for tuition remission, medical expense deductions, housing benefits, and tax-exempt financing.

Additionally, there are some other provisions[9] such as:

- Section 529 qualified tuition programs: Allows up to $10,000 in distributions, on a per-student basis, for private school tuition (effective for distributions made after December 31, 2017).
- Unrelated business income separately computed: Requires that unrelated business income tax (UBIT) be computed separately with respect to each trade or business (effective for taxable years beginning after December 31, 2017 (i.e., fiscal 2019)). The result is that a deduction from one trade or business for a taxable year may not be used to offset income from a different, unrelated trade or business for the same taxable year.
- Unrelated business income: Increases unrelated business income by the amount of any expenses paid or incurred by the exempt organization for qualified transportation fringe benefits, a parking facility used in connection with qualified parking, or any on-premises athletic facility, provided such amounts are not deducted under section 274.
- Advance refunding bonds: Repeals the exclusion from gross income for interest on a bond issued to advance-refund another bond.
- High earners: Imposes a 21% excise tax on remuneration to the top-five highest-paid employees above $1 million.

[9] Net Assets Blog. December 18, 2017. Jennifer Osland Hillen. "Final Tax Bill Spells Some Relief for Independent Schools." https://www.netassets.org/blogs/net-assets/2017/12/18/final-tax-bill-spells-some-relief-for-independent

OTHER

Are there any potential impacts from the new law to Socially Responsive Investing (SRI) or Environmental/Social/Governance (ESG)?

Based on conversations we had with two ESG/SRI managers, we believe at the corporate tax level it will benefit ESG companies the same way it would benefit any other company. Paying federal taxes at a 21% rate as opposed to a 35% rate reduces tax payments, increases cash flow, and will improve the overall value of investments using a discounted cash flow method of valuation.

We also believe elements of the new tax law are likely to exacerbate two pre-existing ESG issues: income inequality and environmental impact. Given this, we suspect advocacy and policy work on behalf of asset owners will continue to be of great importance.

In terms of renewable infrastructure (solar and wind), the Investment Tax Credit (ITC) and the Production Tax Credit (PTC) were left in place by the bill, which should be viewed as a modest positive.

The bill also keeps in place (somewhat) the Base Erosion Anti-Abuse Tax (BEAT) provision. This provision was a major worry for the industry throughout the tax bill negotiations, but a last-minute amendment keeps 80% of the value of both the ITC and PTC.[10]

Does the new tax law require organizations to make any changes to retirement savings plans they sponsor?

Retirement Savings Incentives—401(k)s, 403(b)s, and IRAs—are unaffected.

The new law does not call for changes in existing retirement savings incentives and therefore preserves the favorable tax treatment and contribution limits for 401(k)s, IRAs, and other retirement savings accounts.

The new law does call for an end to Roth IRA recharacterizations starting in 2018, but allows for them in 2017. Recharacterizations have allowed taxpayers to undo a Roth IRA conversion for a limited time, and was often useful if the value of the converted investments fell.

Given its recent passage, there are still many open questions about the new tax law, its impact on market segments, and the broader U.S. economy.

We expect there may be clarifying regulations, technical corrections, and further interpretations to provisions in this legislation.

Additionally, the new law may be challenged in the courts.

Given this uncertainty, FEG will continue to monitor potential impacts to institutional investors throughout 2018, and provide updates as they impact the investment landscape. To receive them, please visit us at www.feg.com/subscribe.

[10] Baker Botts LLP. December 20, 2017. "Tax Reform Act – Impact on Renewable Energy Projects." https://www.lexology.com/library/detail.aspx?g=46461733-7c75-460f-b9a4-9c44e319dee8

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