

A letter from

# Bahl & Gaynor's Chairman



William F. Bahl, CFA, CIC  
Co-Founder & Chairman  
Bahl & Gaynor

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## Tax Reform = Dividend Payoff

Our last newsletter entitled "Time In the Market" was penned as the Tax Cuts and Jobs Act of 2017 was being debated in Congress.

Now that the Act has become law, it represents a game-changer for Corporate America. There are three core tenants of the new tax legislation that target businesses: a lower statutory corporate income tax rate, the adoption of a territorial tax regime and deemed repatriation. We will examine each of these items over the following pages in greater detail and in order of increasing economic impact. We conclude by analyzing the relative attractiveness of various uses of tax savings and argue for a dividend payoff as a notable benefit of tax reform to shareholders.

## Deemed Repatriation

The least economically significant, but by no means unimportant, tenant of corporate tax reform is the concept of deemed repatriation. It is less economically significant than the reduction in tax rates and adoption of a territorial tax regime because of the policy's short-lived impact, but was included in the Act to generate near-term tax revenue to finance the other two reform elements. Deemed repatriation is essentially the combination of a tax holiday and transition tax:

- It is a *tax holiday* in the sense that repatriated foreign earnings are taxed at a favorable effective 15.5% rate for cash and 8.0% rate for assets other than cash, both much lower than the pre- or post-reform statutory tax rate;
- Deemed repatriation is a *transition tax* in that it imposes a one-time charge on accumulated foreign earnings of US corporations not previously repatriated as part of the transition to a new territorial tax regime.

Although difficult to analyze, it is hard to argue the economic effect of deemed repatriation as anything but positive. Once foreign held cash is repatriated and the aforementioned tax has been paid, corporations have several options in how they choose to deploy these funds. Companies could: **1.** pay down outstanding debt; **2.** invest in their business through capital expenditures (capex); **3.** acquire companies through merger and acquisition (M&A) activity; **4.** repurchase common stock; and/or **5.** increase dividends.

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# Territorial Tax Regime

The adoption of a *territorial* tax regime aligns domestic tax policy with the framework used by the vast majority of our global trading partners. Previously, the US operated under a *global* tax regime whereby a company headquartered domestically would pay corporate income tax on *all* income earned – regardless of whether it was earned in the US or overseas. Granted, a corporation would only pay tax on foreign earnings “repatriated” to the US, so most companies would elect to keep foreign earnings abroad through a deferral option – forestalling taxation indefinitely. The consequence of this taxation system and deferral option in an increasingly global world was the buildup of large cash balances outside the US within foreign subsidiaries of domestic companies. This led to inefficient capital decisions such as borrowing money domestically (using unrepatriated foreign earnings as collateral) to pay dividends. Now it becomes evident why deemed repatriation was included in tax reform as a means of “correcting” the shortcomings of a prior global tax framework.

The new territorial system addresses the greatest inefficiencies of the global framework directly. The US will now tax only domestically generated income and exempt most or all foreign-sourced income. This method of taxation is consistent with all other G-7 countries (Canada, France, Germany, Italy, Japan and the United Kingdom) and many OECD nations. Thus, our system better aligns with other developed economies and should result in a less distorted flow of capital through the global corporate system, fostering more efficient capital deployment decisions.

# Lower Statutory Tax Rate

The greatest effects of tax reform will be felt through a reduction of the statutory corporate income tax rate from 35% to 21%. The guiding principle behind this reduction (like that of implementing a territorial tax regime) is to align US tax rates with that of our major trading partners. The last change in tax rates was precipitated by the Tax Reform Act of 1986. At that time corporate tax rates in developed countries were around 35%. Over the past 30 years, there has been a worldwide migration of rates toward the 20% range (*pictured on the following page*) with the notable exception of the US. The consequences of this are well known: US-made goods became less competitive in world markets, US companies came to prefer foreign domiciles (*inversions*), foreign companies began to acquire US companies, and the aforementioned accumulation of foreign-earned profits deferred from taxation in the US reached a fever pitch.

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# Financial Planning Update

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 into law. Regarding personal taxation, one of the main areas of focus was a temporary increase of the estate, gift, and generation-skipping transfer (GST) tax exemption. The exemption amount approximately doubled to \$11.18 million for individuals and \$22.36 million for married couples. An important point to highlight is that the Act will sunset on 12/31/2025 unless Congress makes permanent or extends these changes before this date. At that time, the exemptions will revert to their 2017 levels, adjusted for inflation.

The passage of the Act creates planning opportunities involving the use of strategies that allow individuals to lock in their current exemptions and possibly avoid future transfer tax. One or more of the strategies below may be beneficial to you under the new tax law.

**LIFETIME GIFTS** – Using the increased exemption amount to make additional tax-free lifetime gifts allows individuals to transfer significant assets to others, sheltering retained assets and future growth of gifted assets from estate tax. However, unlike assets transferred at death, it is important to note that assets gifted during your life **will not** receive the benefit of a step-up in cost basis.

**TRUSTS** – Many trusts are structured to be funded according to formulas based on the total exemption amount in effect on the decedent’s date of death. If this type of trust is funded prior to 2026, it may be funded with substantially more assets than originally intended when the original trust was drafted. With the increased exemption amounts noted above, it may be time to review trust strategies with an estate planning professional.

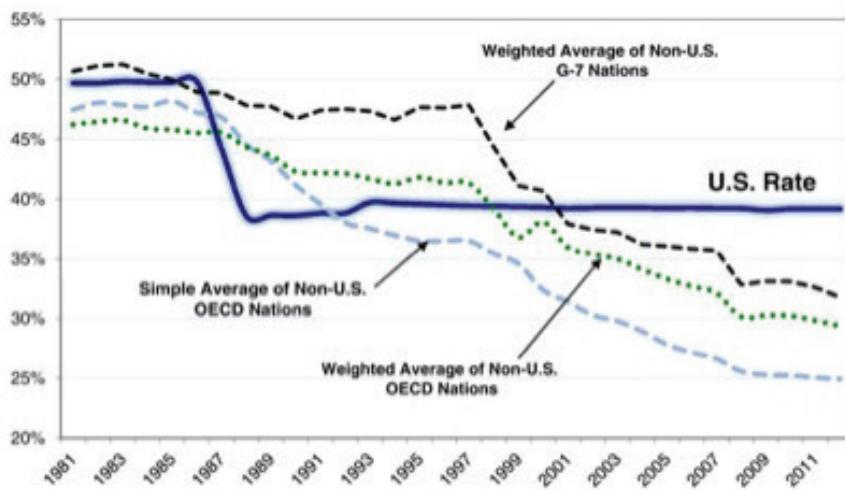
**529 PLANS** – The new tax law permanently expands the benefits of 529 college savings plans. These plans allow individuals to take tax-free withdrawals for qualified educational expenses. Beginning in 2018, these withdrawals can also be used for primary and secondary education, not just higher education expenses.

**CHARITABLE GIVING** – The limitation on deducting gifts to public charities increased from 50% to 60% of adjusted gross income. With the increased exemption limits for the gift and estate tax, charitable giving may be a less effective estate planning tool.

The passage of the Act may have an impact on your current estate plan. Bahl & Gaynor’s role as your investment counselor includes coordinating dialogue between you and your estate planning and tax professionals to ensure current strategies will continue to serve your family’s objectives. Please reach out to your portfolio manager to explore potential next steps regarding any of these topics.

## Lower Statutory Tax Rate *Continued*

### Statutory U.S. Corporate Tax Rate Compared to OECD Averages 1981-2012



Source: Tax Foundation, 2018.

## Long-term Effects of Tax Reform

The longer-term ramifications of recently enacted tax reform cannot yet be fully known. But recent surveys, one of which was conducted by Evercore/ISI, have attempted to rank the priorities for use of tax savings. While survey results varied by industry, the greatest priority for allocation was business investment (capex), including increasing wages. The second priority was capital return (share repurchases and dividend increases). Third was M&A activity. Notably, the lowest priority was paying down debt.

Perhaps the impact of this new legislation can best be summarized in a press release excerpt from spice company McCormick & Co. published earlier in the quarter (*Bahl & Gaynor emphasis added*):

SPARKS, Md., March 27, 2018 /PRNewswire/ -- McCormick & Company, Incorporated (NYSE: MKC), a global leader in flavor, **announced plans to reinvest a portion of its incremental tax savings** from the recent U.S. Tax Act into **one-time \$1,000 bonus payments for eligible U.S. hourly employees** in May. The company also announced **plans to accelerate hourly employee wage increases** to ensure more competitive compensation and attract, develop and retain top talent within the organization. The changes will benefit the majority of the company's U.S. based hourly employees.

"At McCormick, we take a long-term view of the people in our organization. We want McCormick to be a great place for people to come work and have engaging and fulfilling careers. The passage of the U.S. Tax Reform Act provides us an opportunity to demonstrate the Power of People, and for the company to show its commitment to the 2-for-1 spirit," said Lawrence E. Kurzius, Chairman, President and CEO of McCormick.

**In addition to employee bonuses and wage increases, McCormick reiterated its plans to use its tax benefits to make strategic investments to drive growth, return cash to shareholders, and pay down debt.**

Similar positions and priorities have been articulated by dozens of large companies and thousands of small public and private companies in the US as a result of these legislative changes.

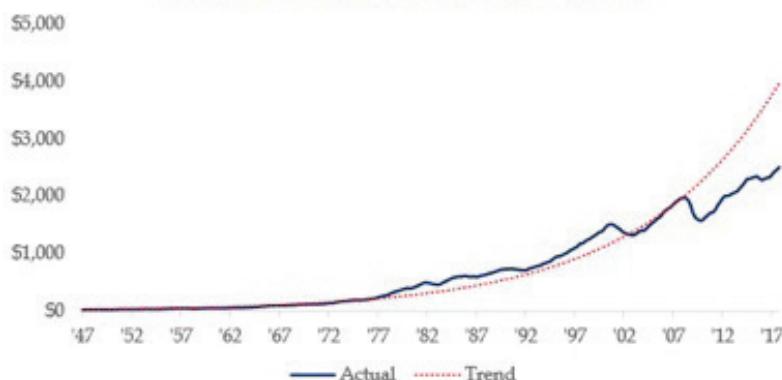
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# Tax Savings Priorities – A Closer Look

Not every company will come to the same conclusions in how they decide to divvy up tax reform savings. But in this section, we examine the priority of use identified in the Evercore/ISI survey and offer our thoughts as to why this particular ordering may exist and what influence it may have on shareholder experience:

1. Capex was identified as the highest priority and this is likely because rates of fixed investment since the financial crisis have been below-trend (see chart below). Further, at full employment it is difficult to find qualified talent, so investing in talented employees through various compensation incentives helps to ensure they are retained. Although capex and compensation are an expense, both are likely worthy investments at this point in the market cycle and could be considered a sustaining element of future shareholder returns.

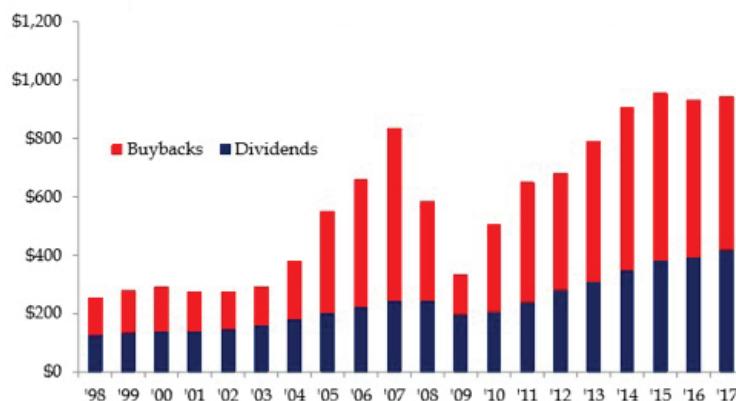
## Non-Residential Fixed Investment (SAAR, \$BN) vs. Non-Residential Fixed Investment Trend



Source: Strategas, 2018.

2. Capital return was listed as the second priority for tax savings deployment – here we will tackle share repurchases. Share repurchases can be viewed as “internal M&A” insofar as they represent investment in a well-known asset (the company’s own stock). Since the financial crisis, public company management teams have favored share repurchases perhaps because they entail less uncertainty than capex or M&A and less commitment than dividends. A notable risk associated with share repurchases is illustrated below when companies bought back a record amount of their own shares in 2007, right before the financial crisis. Bahl & Gaynor supports companies that follow a disciplined repurchase program as only a component of multiple capital return channels. As we are long-term investors, our clients should benefit from disciplined share repurchase activity as *remaining* shareholders of companies, not *departing* shareholders.

## S&P 500 Annual Buybacks & Dividends (\$BN)



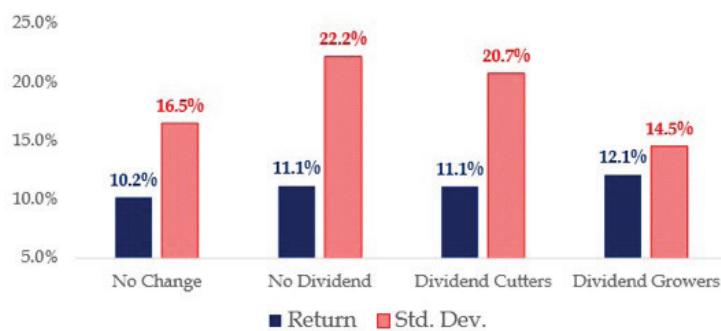
Source: Strategas, 2018.

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## Tax Savings Priorities – A Closer Look *Continued*

3. Dividends are the alternative capital return method to share repurchases. As also illustrated in the chart above, they are a more consistent element of capital return and, as a result, form a core tenet of Bahl & Gaynor's investment philosophy. In fact, companies that pay growing dividends are observed to have less volatile stock price fluctuations relative to returns earned as a group than companies that reduce or eliminate dividends, non-growing dividend companies and companies that pay no dividends altogether (*below*). We will discuss in more specific detail our outlook for dividend growth at the end of this note.

**S&P 500 Annual Buybacks & Dividends (\$BN)**



Source: Strategas, 2018.

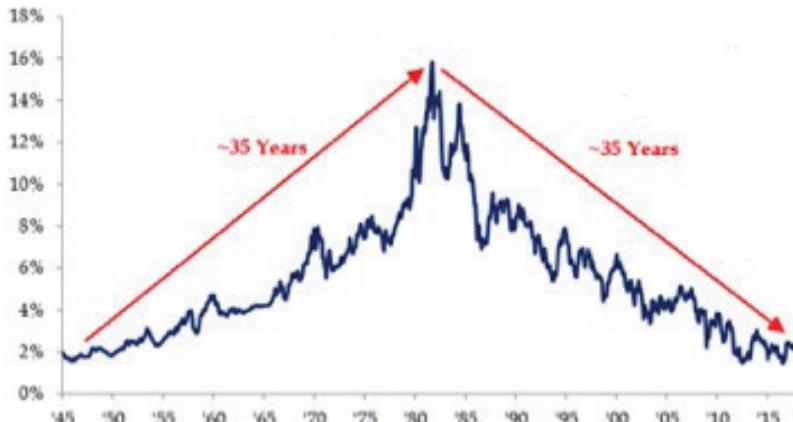
4. M&A can be an important source of transformational growth, but, in many cases, is a riskier use of capital than capex because of the uncertainty surrounding future performance of acquired businesses. Bahl & Gaynor seeks out companies that, like us, have a disciplined investment approach. Many of these companies have stated that a change in tax legislation does not necessarily make M&A more or less attractive – it is the economics that underlie a target business that matters much more in the evaluation of a successful strategy. That said, we support owned companies that take advantage of opportunities meeting their investment criteria and are attentive to the value this should create for our clients.

5. Finally, although there has been much discussion of rising interest rates in the news lately, rates remain low relative to history (*see chart on the following page*). Over the past several years, companies have taken advantage of this opportunity by issuing long-term debt to lock in favorable terms. It is therefore sensible that companies would prefer to expend their tax savings in the preceding ways, as opposed to debt repayment. Moreover, most companies are able to enhance shareholder return by financing their operations through a combination of equity and debt depending on the cost of each financing source. It is unlikely companies would disrupt a cheap financing source by emphasizing excessive deleveraging.

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# Tax Savings Priorities – A Closer Look *Continued*

## U.S. 10-Year Yield (Monthly, Since 1945)



Source: Strategas, 2018.

## Dividend Payoff

### S&P 500 Historical Dividends Per Share and Payout Ratio



Source: Factset, Bahl & Gaynor, 2018.

The concluding thought of this note is the payoff Bahl & Gaynor believes shareholders are set to receive in the form of generous dividend increases over the balance of this year. Anecdotally, the magnitude of dividend increases reported so far among companies owned in our strategies has meaningfully exceeded pre-reform expectations.

The chart above illustrates a 20-year record of annual S&P 500 dividend payments per share and the dividend payout ratio relative to earnings. As can be seen, a steady upward trend of payments has prevailed over the last two decades. The growth of dividends has roughly coincided with earnings growth as the payout ratio has remained range-bound between 30% and 40%. For 2018, based on higher consensus earnings due to tax reform, the S&P 500 payout ratio should drop from approximately 37% in 2017 to 34% in 2018. This includes an expected +11% dividend increase for the index this year – well above the +7% and +5% increases delivered in 2017 and 2016, respectively.

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The evidence presented in this note offers strong support for excellent dividend growth this year, and it is Bahl & Gaynor's belief that dividend growth expectations stated above could prove conservative. Our investment process is designed to identify high-quality franchises that effectively balance their capital use priorities such that when favorable environmental factors (taxes) change, investors share in the benefit.

We thank you for the opportunity to serve your investment needs and we wish everyone an enjoyable start to spring.

*Sincerely,*

**William F. Bahl, CFA, CIC | Co-Founder & Chairman**

255 East Fifth Street, Suite 2700 | Cincinnati, OH 45202

[www.bahl-gaynor.com](http://www.bahl-gaynor.com)

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Investment Counsel

Dividends Pay Dividends®

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