POSITIVE TAX SURPRISES AHEAD

This week House Republicans plan to pass their economic stimulus package The Economic Security and Recovery Act. It's public knowledge that the White House thinks the House tax package is too large. However, surprisingly little has been said about its multi-year impact and, more important for investors, its impact on corporate bottom lines. To kick start a corporate capital investment buying spree that will last through Bush's plan reelection in 2004, Ways and Means tax writers decided to give purchasers of long lived physical capital assets an impressive tax holiday.

Compared to projections, overall corporate income tax receipts would be *cut by $70 billion in 2002, $42 billion in 2003, and $33 billion in 2004. By comparison, corporations paid $189 billion in federal income taxes in 2000!* In 2005, corporate taxes would *increase* by 5 percent for the balance of the decade. This is a time when averages obscure as well as inform. Profitable corporations that buy more than the average amount of capital equipment will enjoy even higher tax reductions while those that have well below average capital expansion plans will see only minor changes in their payments to Uncle Sam. As an investor, you will want to own more of the former than the later type of corporation. While the White House and the Democratic Senate will scale back the House bill before Bush signs it later this year, it's clear which direction Washington is headed to head off a lengthy recession. Washington is picking favorites. To the adage, "Don't fight the Fed," we also suggest following the principle: Don't fight the Congress.

Appreciating Depreciation

According to the IRS, the average U.S. corporation has pre-tax earnings of 5 cents on the dollar. Four cents of the 95 cents of its costs is for depreciation of physical capital. The tax laws for determining depreciation have a powerful effect on taxable profit, and therefore, tax liability. Boost depreciation charges from 4 cents to 6 cents and taxable income falls to 3 cents on the dollar. Tax payments fall, too, by 40 percent.

Congressional reformers want to do just that. Here is how. Under current law, physical capital assets placed in service today in general are lumped into categories with specified tax lives, most commonly of 3, 5,7, 10, 12, 15, 20, 27.5, or 39 years. Property with lives of 10 years or less may be depreciated under the 200 percent declining balance method., switching to straight line when that method becomes faster. Property between 12 and 20 years may be depreciated using the less rapid 150 percent declining method before switching to straight line. The curious can consult IRS Publication 946 for details. (http://ftp.fedworld.gov/pub/irs-pdf/p946.pdf)

The House bill proposes to jump start the deductions by allowing companies to deduct in the first year 30 percent of the purchase price of a capital asset, plus depreciating the remaining

70 percent of cost basis under current rules, provided the asset has a tax life of 20 years or less. Using a 8 percent discount rate, it possible to quantify just how generous the House's reformers intend to be. All entries are expressed per dollar of physical capital purchased.

NET PRESENT VALUE OF DEPRECIATION DEDUCTIONS, 8% DISCOUNT RATE

Tax Life Class	Net Present Value of Current Law Depreciation Deduction Stream	House Bill	Subsidy as a Percent of Purchase Price
20	51 cents	66 cents	15%
15	60 cents	72 cents	12%
12	63 cents	74 cents	11%
10	71 cents	79 cents	8%
7	77 cents	84 cents	7%
5	81 cents	87 cents	6%
3	86 cents	90 cents	4%

What emerges is a plan to enhance the incentive to purchase physical capital assets with the incentive growing with the length of the tax life of the asset. Buy $1,000,000 in two-year old horses with 3 year tax lives, then the House will cut your taxes by $40,000. Install $1,000,000 in railroad hydraulic electric generation equipment which has a tax life of 20 years, then they will forgive $150,000. It's not unreasonable to treat this program as providing a 4 percent to 15 percent investment tax credit for the purchase of physical capital. The 30 percent up-front bonus disappears on September 11, 2003.

Like temporary sales tax holidays, these temporary investment credits probably won't stimulate many additional long-term purchases. If the elasticity of demand for capital assets is one, then it will induce an increase in capital purchases up to 15 percent. Therefore, at least 85 percent of such investments would be made anyway. Happy CEOs still will pocket the tax savings. Consequently, accelerating depreciation is likely to have only a small impact on long-term employment and the real economic growth rate.

However, it's unnecessary to speculate on the macroeconomic benefits to benefit as a speculator. The strategy is straightforward. Identify companies that historically purchase an above average amount of physical capital. These companies will see the largest dollar drop in their taxes. Then, compare the value of their tax savings with the market capitalization of the companies. A company that will receive $500 million in present value tax benefits when the law passes, for example, should go up 10 percent if its market value now is $5 billion..

The best way to do this is to question managements directly. Ask about their plans to purchase plant and equipment in the next two years, especially longer lived assets. For those who want to get started now, we have developed a proxy variable that should identify many of the industries most likely to be helped by accelerated depreciation. To do this, we rely on the IRS's "Corporate Statistics of Income" which aggregates corporate tax return data into industry subtotals. The most recent one published is for calendar year 1997. One column of their data lists "depreciation deductions" taken by industry. Another column lists "taxable income." The ratio should pinpoint fruitful sources of corporate officials to question. If tax depreciation suddenly leaps because of help from Washington, then companies with the highest ratios will see the most dramatic falls in their taxable incomes, and consequently in their contemporaneous tax payments. These are promising ponies to bet on.. For its own purposes, Washington want them to be winners. Here are 20 industries that popped up when we performed this exercise. You can generate your own ideas by exploring the IRS's data at www.irs.gov/tax_stats/soi/corp_alt.html.

"Economic Security and Recovery Act" Winners

	Industry	Income subject to tax ('000)	Depreciation ('000)	Depreciation/ Income subject to tax
	Total returns of active corporations	**683,792,847**	**513,137,459**	**75%**
1	Auto repair and services	888,682	7,756,937	873%
2	Auto repair; miscellaneous repair services	1,447,926	8,415,544	581%
3	Local and interurban passenger transit	196,122	942,543	481%
4	Logging, sawmills, and planing mills	440,875	1,785,451	405%
5	Gasoline service stations	291,521	934,365	321%
6	Metal cans and shipping containers	172,458	552,342	320%
7	Agricultural services, (except veterinarians),forestry, fishing, hunting and trapping	525,565	1,649,933	314%
8	Trucking and warehousing.	3,513,383	9,767,762	278%
9	Motion picture production, distribution, and services	762,917	2,114,199	277%
10	Farm-product raw materials	568,811	1,456,007	256%
11	Motor vehicles and equipment	16,398,533	40,774,069	249%

12	Railroad transportation.	1,773,474	4,015,963	226%
13	Dimension, crushed, and broken stone; sand and gravel	158,979	358,752	226%
14	Pulp, paper, and board mills	2,987,660	6,471,436	217%
15	Motor vehicle dealers	1,734,201	3,732,322	215%
16	Millwork, plywood, and related products	609,455	1,296,550	213%
17	Lumber and wood products	1,709,361	3,522,786	206%
18	Nursing and personal care facilities	595,928	1,204,100	202%
19	Agricultural production	1,808,757	3,644,428	201%
20	Medical laboratories	180,138	353,217	196%

Source: Internal Revenue Service: 1997 Corporate Statistics of Income

The Corporate Alternative Tax

Under a peculiarity of corporate tax law, companies that invest "too much" in plant and equipment during downturns can fall into the jaws of the "corporate alternative minimum tax" system. This can happen now, even before first year 30 percent depreciation accelerations are considered. To remove this disincentive, the House bill repeals the corporate alternative minimum tax. Obviously, if accelerated depreciation isn't removed from the list of "corporate tax preferences" subject to the minimum tax, then the strategy of using tax policy to boost physical capital investment now will fail. Fortunately, Democratic tax writers appear to agree even as they howl that other changes needlessly refund $25 billion in alternative minimum tax credits.

Summary of the Economic Security and Recovery Act of 2001

To better follow this important tax debate that should conclude within one month from now with a signing ceremony at the White House, we attach a summary of the revenue impact of all tax provisions expected to be voted on this week by the full House. If any interest you, call us for details.

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Attachment One: Summary of Key Provisions of The Economic Security and Recovery Act of 2001

	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-06	2002-11
Cost Recovery Provisions													
30% expensing of capital assets having depreciable lives of 20 yrs or less	9/11/01, sunset after 36 months	(39,301)	(36,125)	(30,295)	6,904	22,299	18,165	15,136	11,649	8,195	5,484	(76,518)	(17,889)
Increase expensing to $35,000 for 24 months	12/31/01	(852)	(1,406)	(142)	682	466	351	267	188	116	65	(1,251)	(264)
15-year life for leasehold improvements	09/11/01	(78)	(202)	(369)	(533)	(684)	(806)	(917)	(1,050)	(1,186)	(1,294)	(1,865)	(7,118)
Total Cost Recovery		**(40,231)**	**(35,730)**	**(28,802)**	**9,058**	**24,087**	**19,717**	**16,494**	**12,796**	**9,135**	**6,266**	**(79,634)**	**(25,271)**
5-year carryback of net operating losses	**9/11/01, 36 mo. sunset**	**(4,704)**	**(3,528)**	**(1,910)**	**3,418**	**3,026**	**1,967**	**867**	**185**	**114**	**114**	**(3,699)**	**(452)**
Repeal corporate AMT, fully refund AMT credits	**12/31/00**	**(25,397)**	**822**	**1,209**	**736**	**189**	**(72)**	**(13)**	**(104)**	**(533)**	**(911)**	**(22,441)**	**(24,074)**
Defer multinational business inc. provisions	**12/31/01**	**(260)**	**(1,252)**	**(1,441)**	**(1,659)**	**(1,911)**	**(2,202)**	**(2,537)**	**(2,921)**	**(3,342)**	**(3,821)**	**(6,523)**	**(21,346)**
Provisions Affecting Individual Taxpayers													
Provide $300/$500/$600 rebates for individuals	date bill enacted	(13,733)										(13,733)	(13,733)
Accelerate 25% individual income tax rate	12/31/01	(12,816)	(18,862)	(12,196)	(7,685)	(2,106)						(53,665)	(53,665)
Increase AMT exemption	12/31/01	(717)	(2,063)	(2,315)	(1,250)							(6,345)	(6,345)
Increase deduction of capital losses from $3,000 to $4,000 for 2001 and $5,000 for 2002	for taxable years 2001 and 2002 only	(840)	(1,224)	83	54	25						(1,903)	(1,903)
Allow adj.net capital gains to qualify for 18%/8% rates	10/12/01	(535)	1,451	(1,033)	(2,420)	(2,385)	(1,810)	(1,318)	(966)	(637)	(759)	(4,922)	(10,413)
Miscellaneous		(13)	(59)	(33)	1	1	1	1	1	1	1	(103)	(99)
Total Indiv. Taxpayer		**(28,654)**	**(20,757)**	**(15,494)**	**(11,300)**	**(4,465)**	**(1,809)**	**(1,317)**	**(965)**	**(636)**	**(758)**	**(80,671)**	**(86,158)**
Extend expiring provisions	**various 2001 dates**	**(210)**	**(1,013)**	**(1,039)**	**(159)**	**(35)**	**47**	**76**	**78**	**76**	**78**	**(2,455)**	**(2,102)**
Cost of Proposed Bill		**(99,456)**	**(61,458)**	**(47,477)**	**94**	**20,891**	**17,648**	**13,570**	**9,069**	**4,814**	**968**	**(195,423)**	**(159,403)**