



HEDGEYE  POTOMAC RESEARCH

YES IT'S REAL THIS TIME

NOVEMBER 6, 2017

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STATE OF PLAY

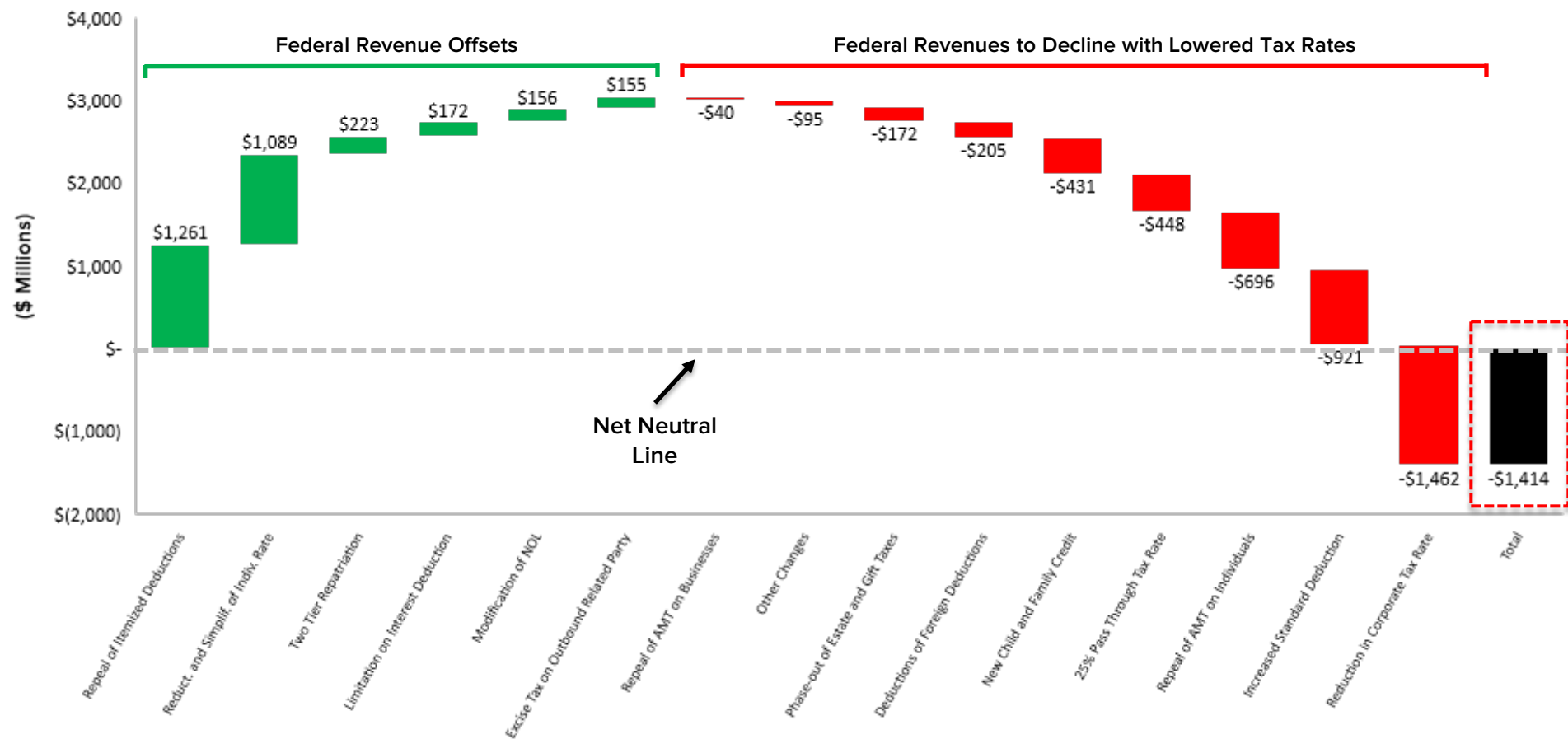
STATE OF PLAY

- Crown jewel of Republican agenda
- House Ways and Means released bill Thursday midday
- Chairman's mark released over weekend with minor adjustments and amendment to individual rate indexing
- Response was generally positive amongst Hill Republicans
- Failure is not an option

REPUBLICAN PHILOSOPHY

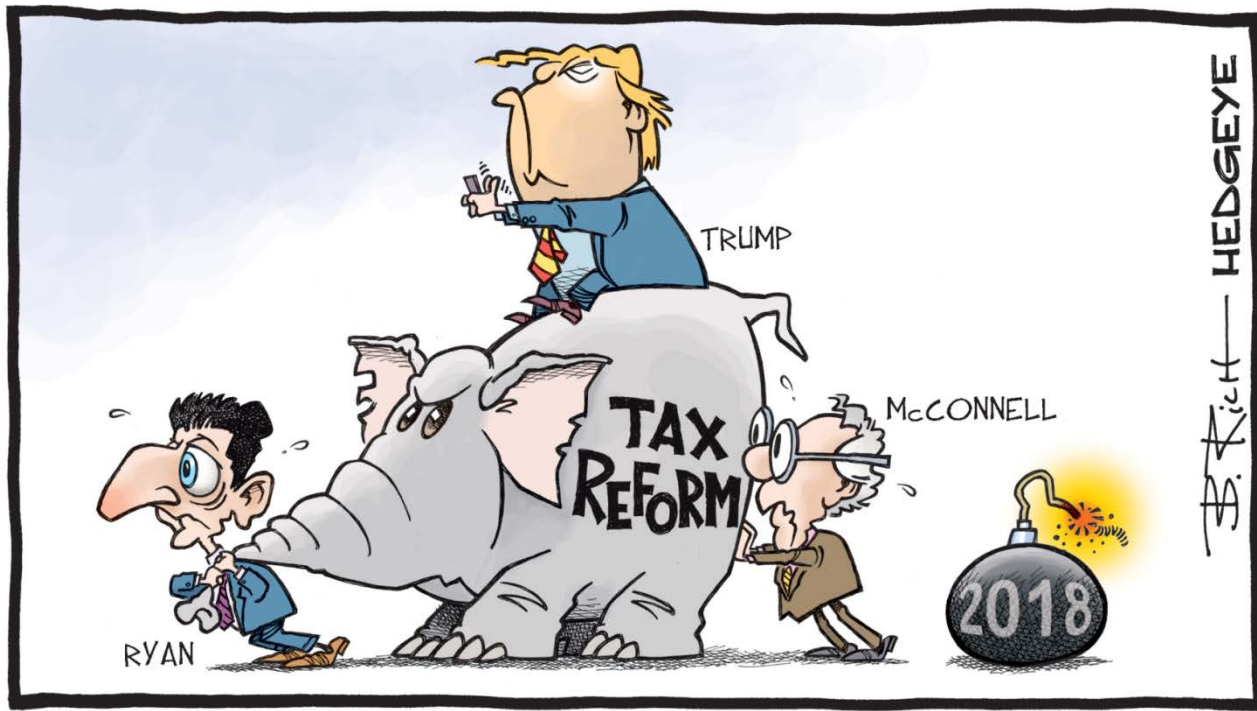
- Tax reform is fertile and familiar ground to Republicans –while there is some division in the Party, all stripes want to get to “yes”
- If you understand the driving Republican principals, you can see where the package is going
- Pro-business – will be focused on economic growth and job creation
- Fairness – making sure it focusses on the middle class and small businesses, not just wealthy and corporations

DEFICIT MATH



COMPARISON OF MAJOR PROVISIONS

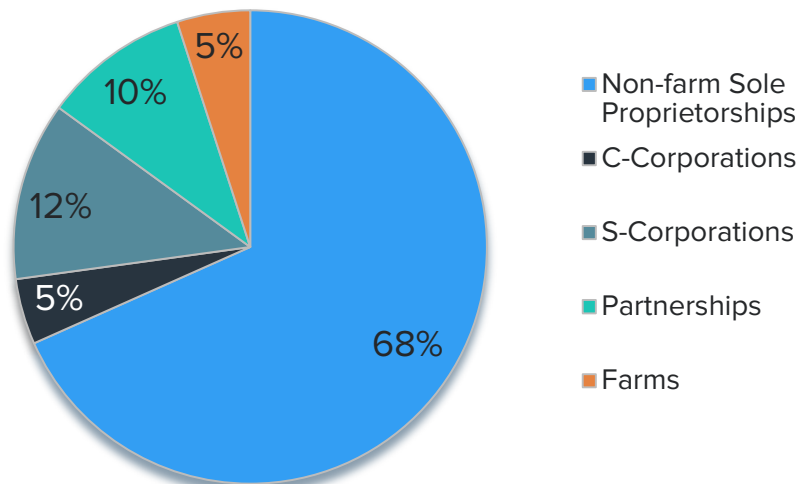
PROVISION	CURRENT LAW	BIG SIX PROPOSAL	HOUSE WAYS AND MEANS BILL	ANTICIPATED SENATE BILL
Corporations	4 brackets; 15, 24, 25, 35%	20%	20%	20%
Pass-through Entities	39.6% or applicable individual rate	25%	25% on all passive income; Bifurcates active income into business (25%) and ordinary (Income tax rate)	25% with guardrails
Individual	7 brackets; 39.6% top rate	3 brackets; 12, 25, 35% rates	4 brackets; 12, 25, 35 and 39.6% rates	4 brackets; 15%, 25%, 35% and 39.6% rates
Estate	Applies to \$5.49M single, \$10.98M couple	Repeal	Repeal after 2023; base amount increased to \$10MM 2017-2023	Repeal - possible phase-in
Alternative Minimum Tax	Separate tax calculation on some returns	Repeal	Repeal	Repeal
Repatriation of Indefinitely Reinvested Foreign Earnings	None		12% tax on cash and cash equivalent assets; 5.25% on other classed	



CORPORATIONS & PASS-THROUGHS

CORPORATE AND PASS-THROUGH RATES

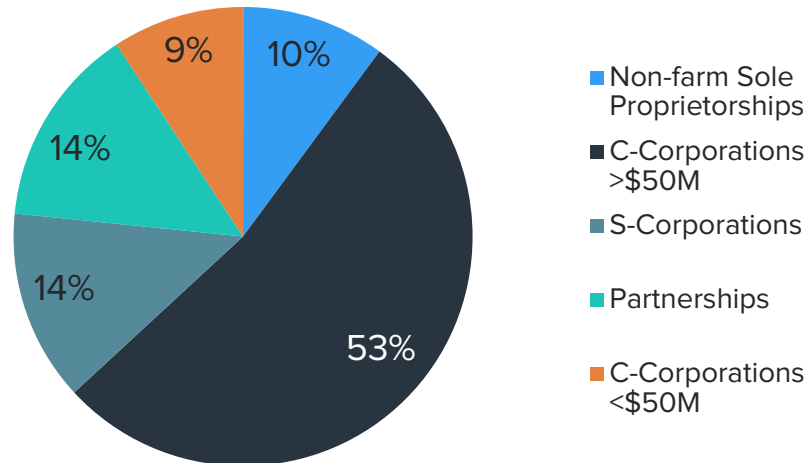
Business Returns, 2014



MOST RETURNS ARE “PASS-THROUGHS”

- Sole Proprietorships, S-Corps, Partnerships are 90% of returns filed
- C-Corps represent just 5% of returns

Business Income By Type, 2014



MOST INCOME IS C-CORP

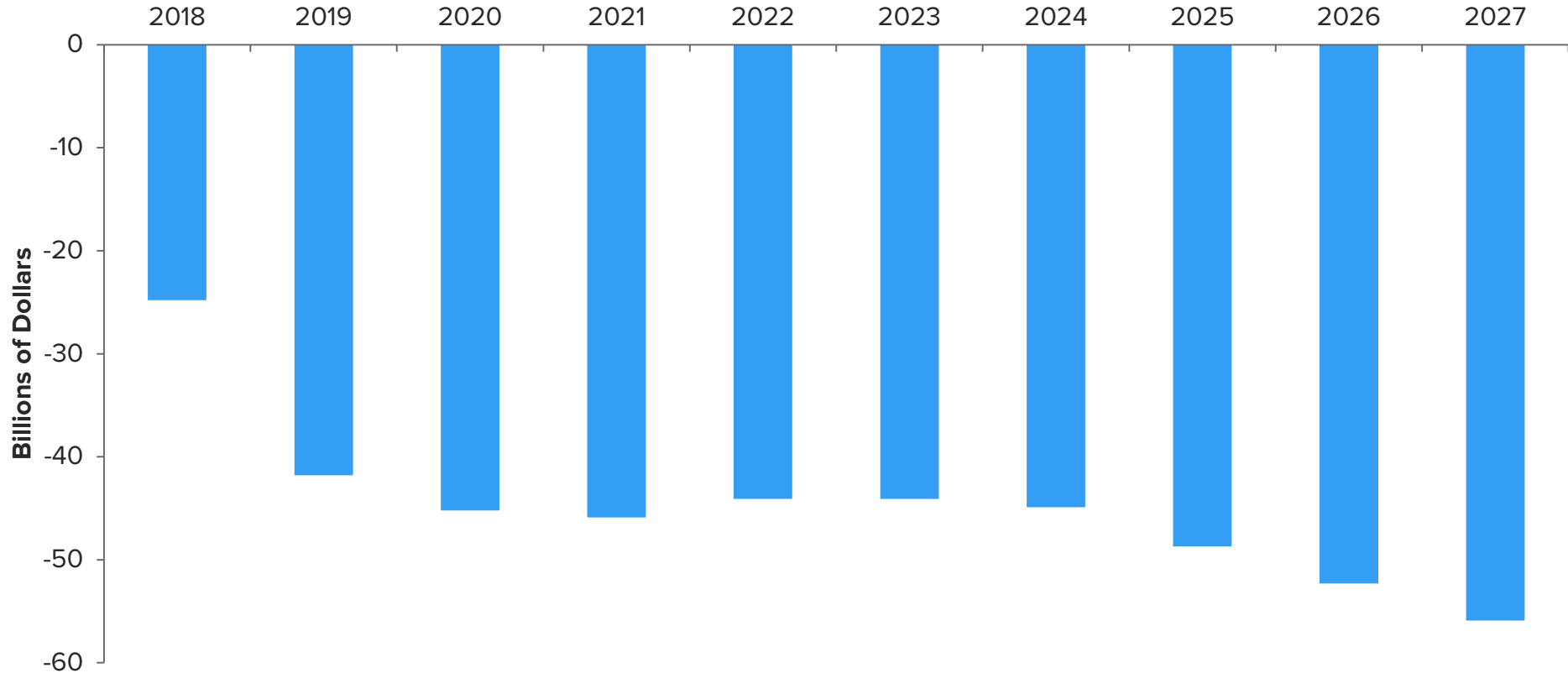
- C-Corps represent 62% of business income
- Farm income is negligible
- Pass-throughs represent balance

NEW PASS-THROUGH RATE

- Applies to “pass-through” entities such as partnerships, sole proprietorships
- Bifurcates income into “business” taxed at 25% and “ordinary” taxed at income tax rate
- Allocation would be 30-70% or using “facts and circumstances”
- Passive business income taxed at 25%

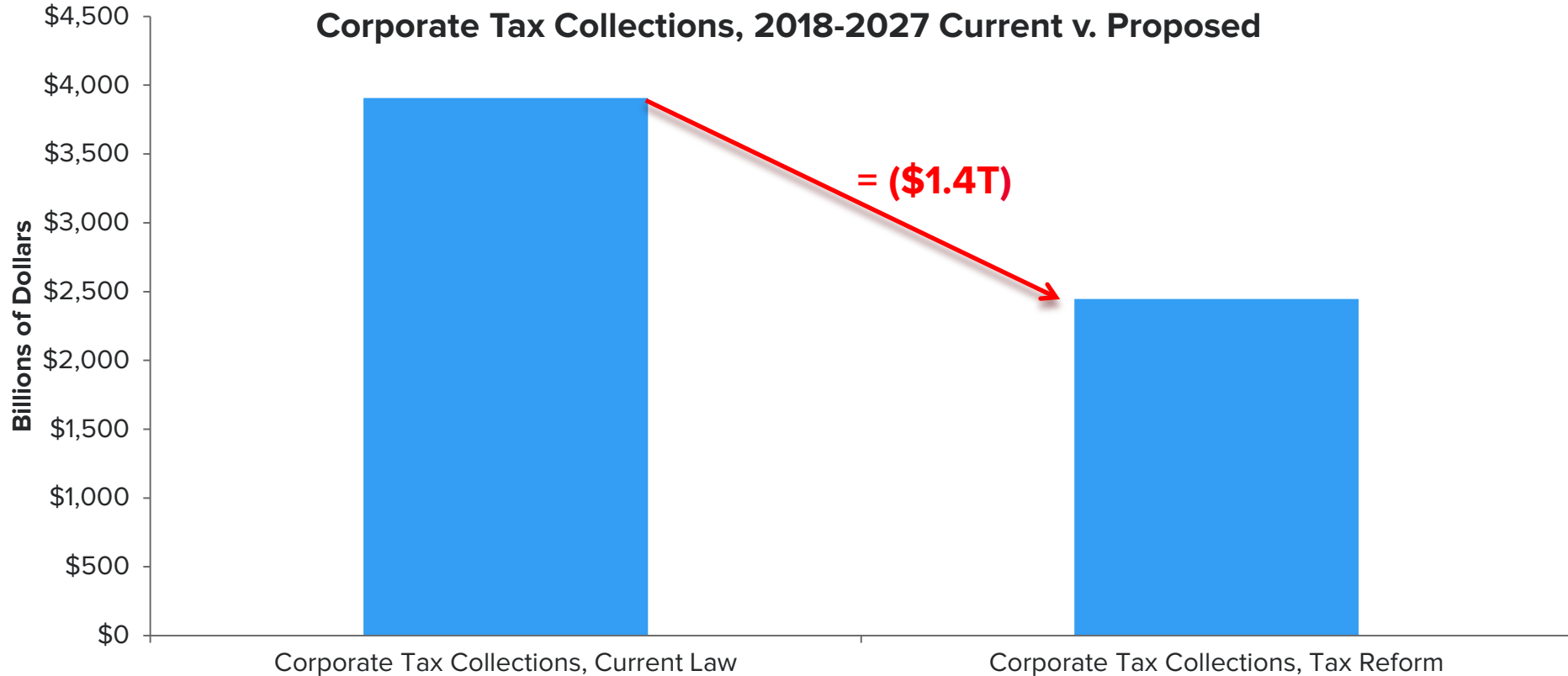
CHANGE IN FEDERAL REVENUES

COLLECTED FROM PASS-THROUGH ENTITIES

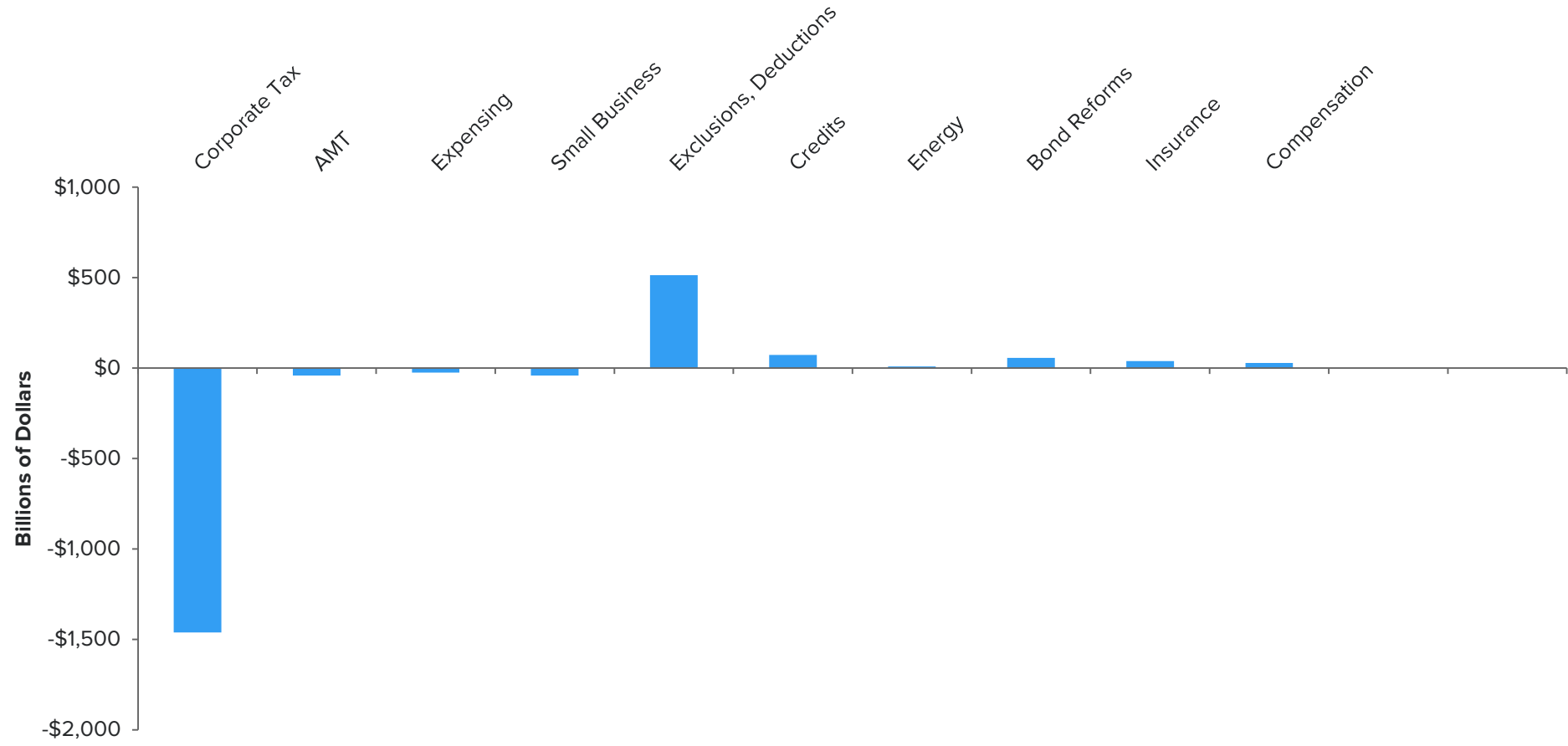


CHANGES IN FEDERAL REVENUES

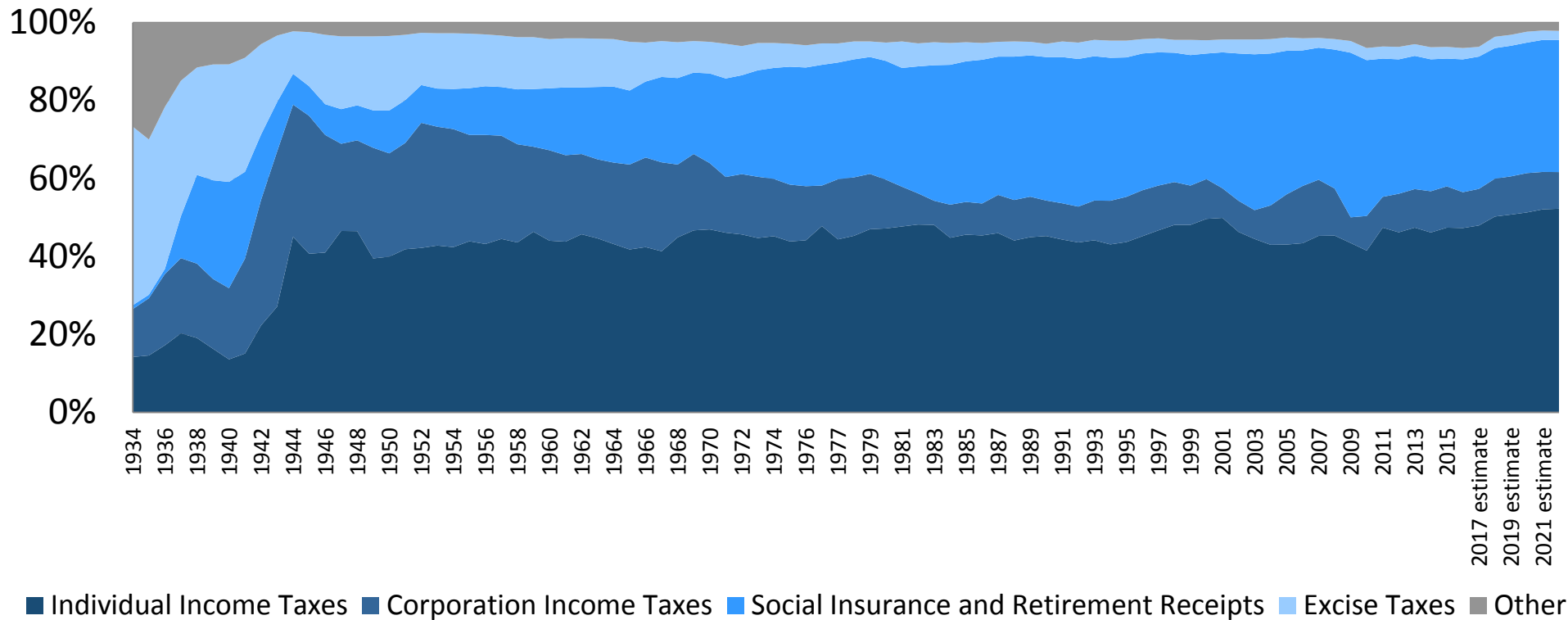
COLLECTED FROM CORPORATIONS



CORPORATE RATE & OFFSETS

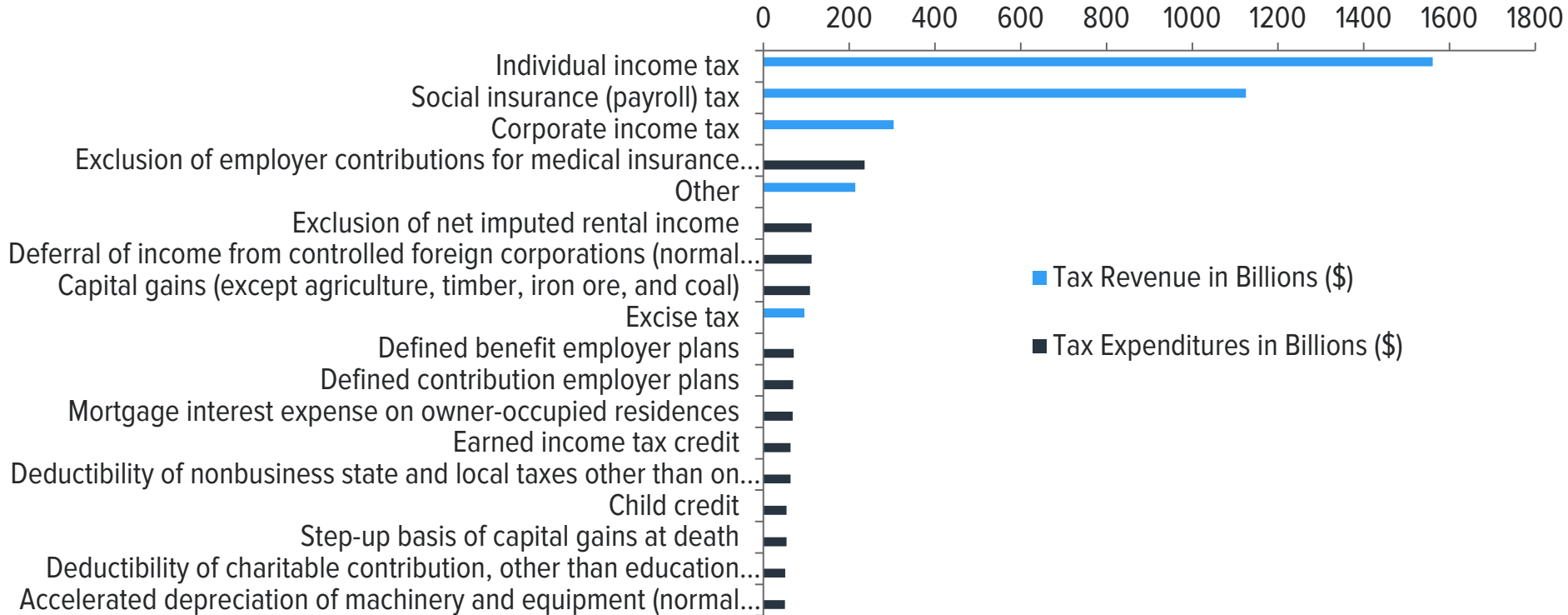


HOW DIFFERENT TAXES FUND GOV'T



TAX REVENUES AND EXPENSES 2016

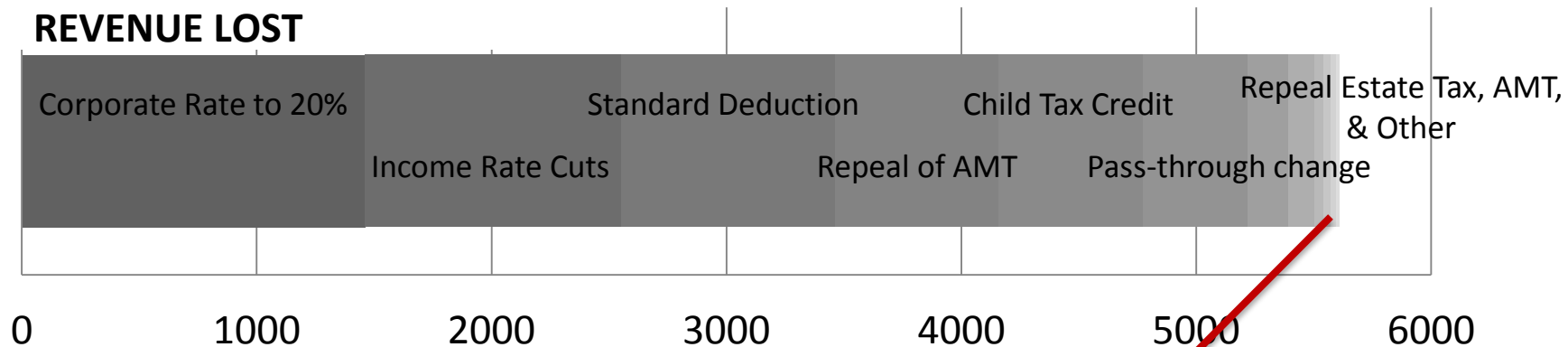
LARGEST FEDERAL TAX BREAKS VS REVENUES



PRICE OF TAX REFORM

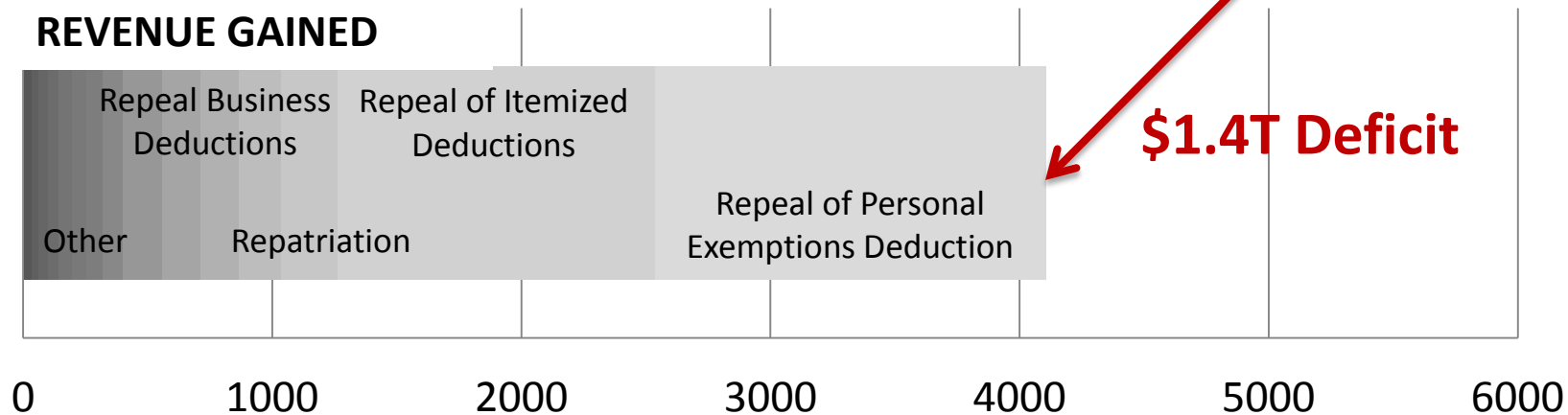
REVENUE LOST

1



REVENUE GAINED

1



\$1.4T Deficit



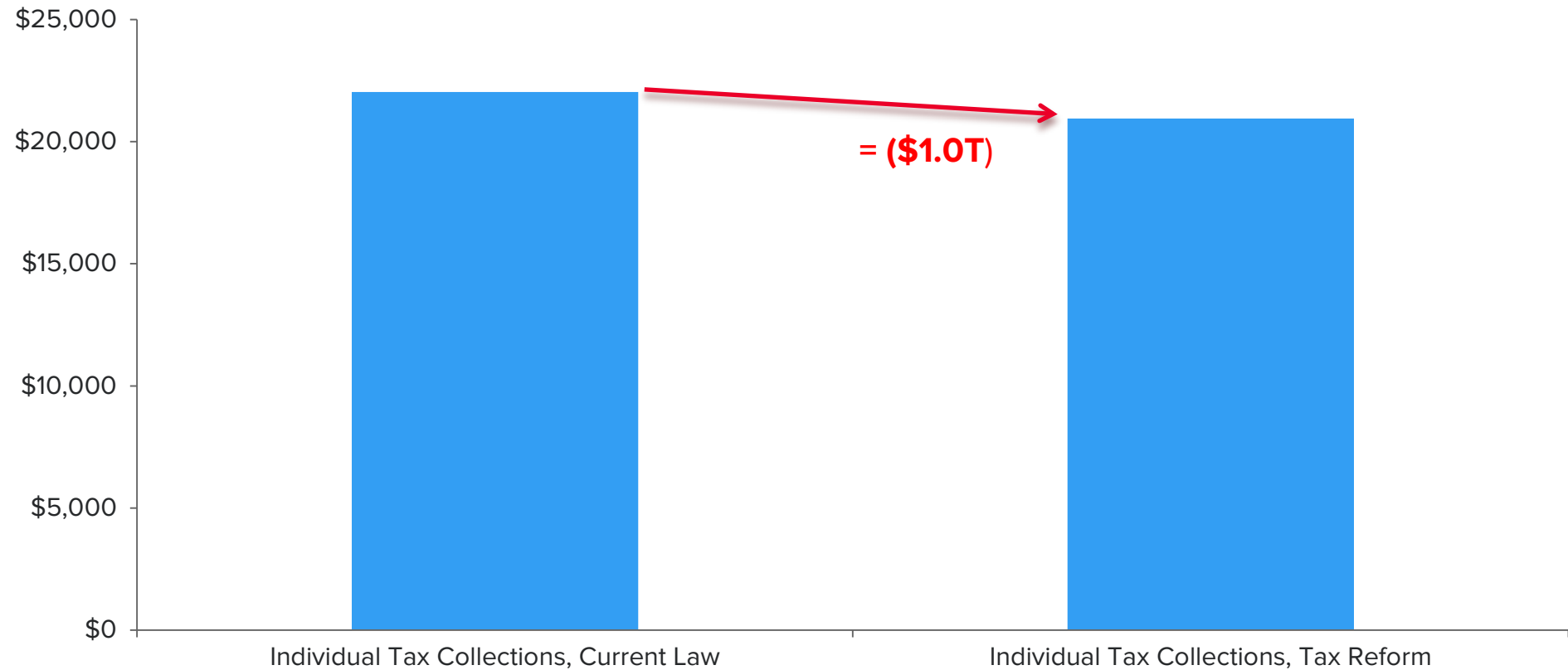
INDIVIDUALS

INDIVIDUAL DEDUCTIONS & CREDITS

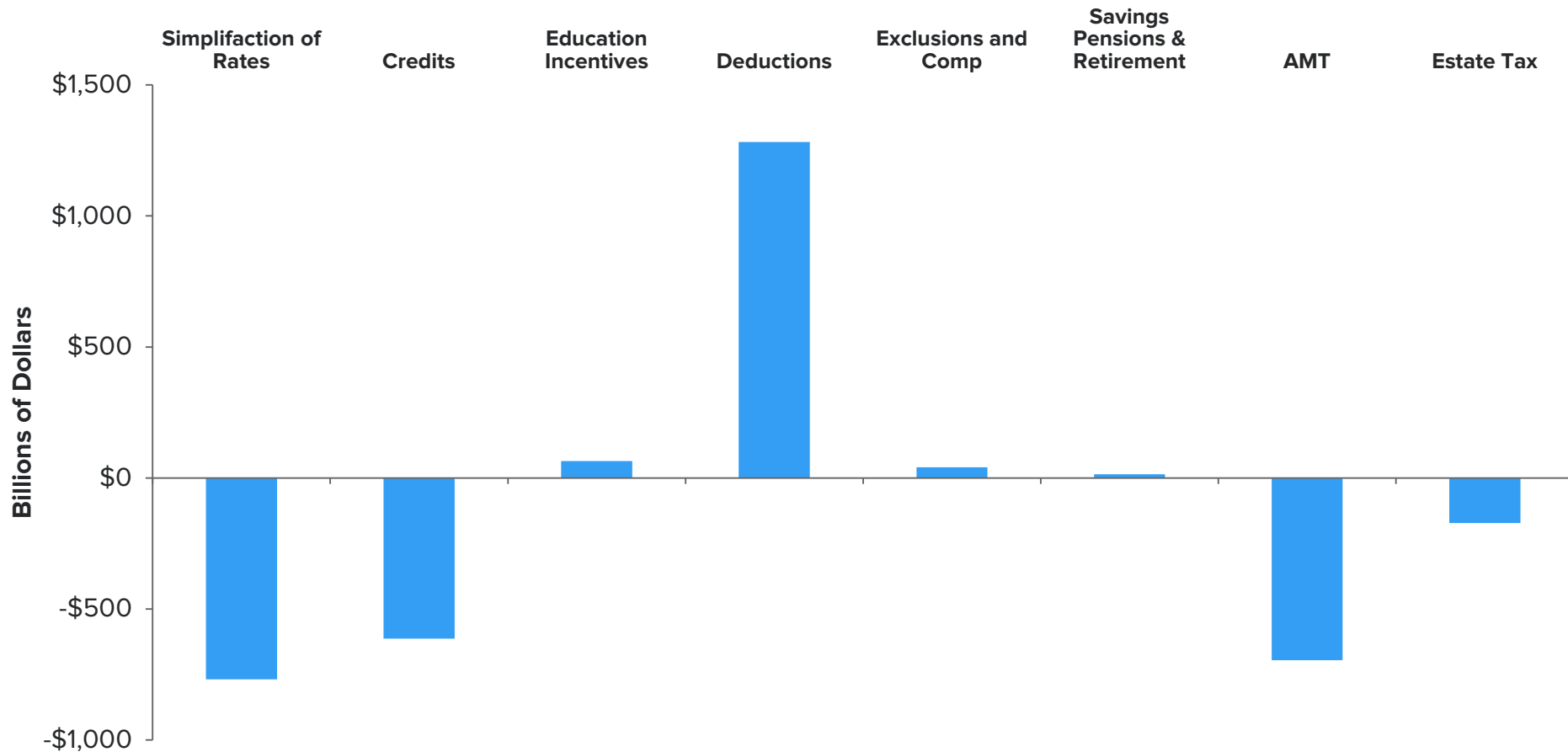
PROVISION	CURRENT LAW	BIG SIX PROPOSAL	HOUSE WAYS AND MEANS BILL	ANTICIPATED SENATE BILL
Standard Deduction	\$6,300 (single); \$12,600 (MFJ)	\$12,000 (single) \$24,000 (MFJ)	\$12,000 (single); \$24,000 (MFJ)	\$12,000 (single); \$24,000 (MFJ)
State and Local Tax Deduction	Itemized deduction for taxes paid	Repeal	Eliminate sales, and income tax deduction, and caps property tax deduction at 10K	Eliminate sales, and income tax deduction, and caps property tax deduction at 10K
Child Tax Credit	\$1,000 per child	Raise “significantly”	\$1,600 per child/ \$300 for non-child dependent	\$1,600 per child
Mortgage Interest	Deduct up to \$1M in mortgage principal; home equity interest eligible; second home eligible	Retain	Reduce deduction to \$500K in mortgage principal on primary residence only; no home equity interest	Reduce deduction to \$500K in mortgage principal
Charitable Deduction	Deduct up to 50% of adjusted gross income	Retain	Increase deduction up to 60% of AGI, but repeal other minor provisions	Increase deduction up to 60% of AGI, but repeals other minor provisions

CHANGES IN FEDERAL REVENUES

COLLECTED FROM INDIVIDUALS

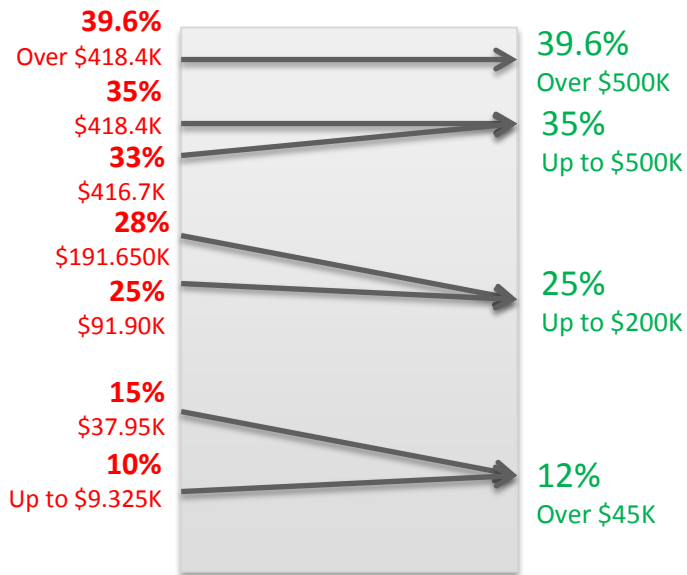


INDIVIDUAL RATE OFFSETS

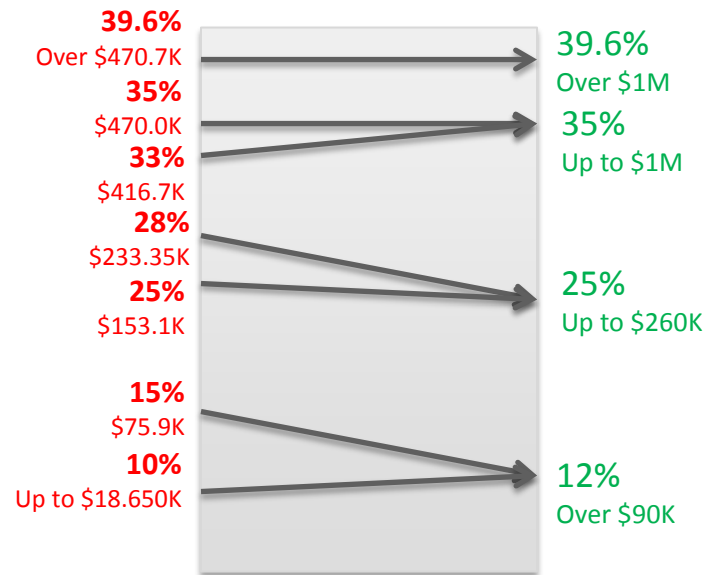


INDIVIDUAL INCOME BRACKETS

INDIVIDUAL FILERS



MARRIED FILERS

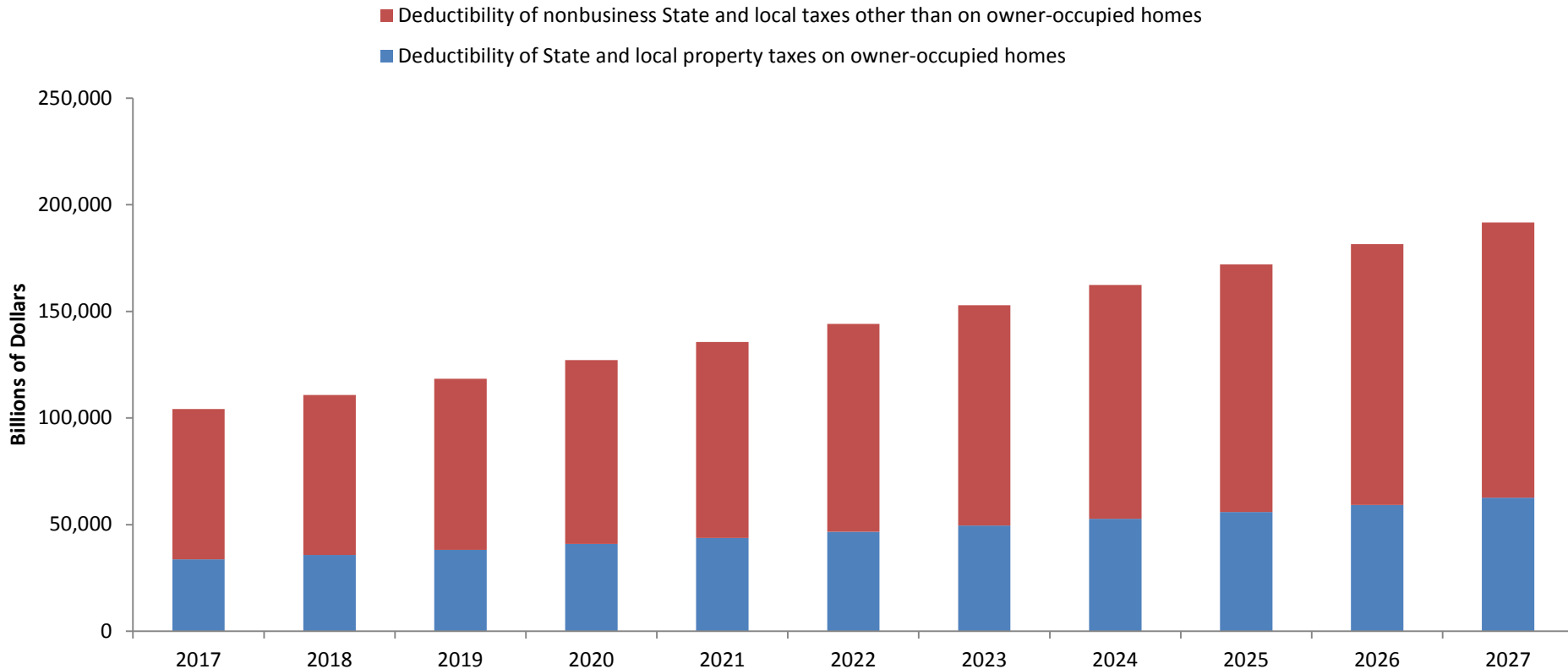


STATE AND LOCAL TAX DEDUCTIONS

- State and local sales and income taxes would no longer be deductible
- Real estate taxes on principal residence only could be deducted up to \$10K

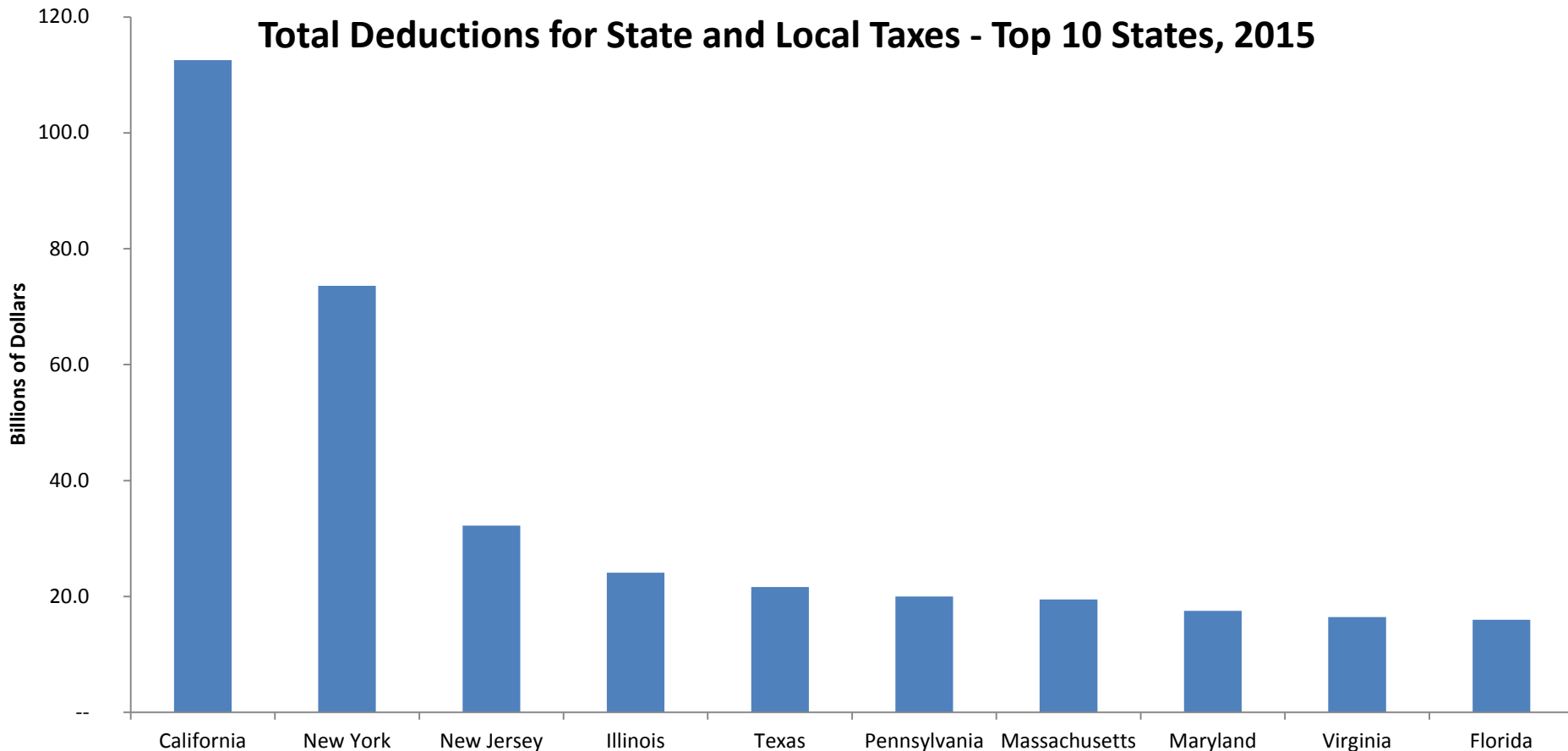
STATE AND LOCAL TAX DEDUCTIONS

Estimated Cost to U.S. Treasury of SALT Tax Expenditures 2017-2027

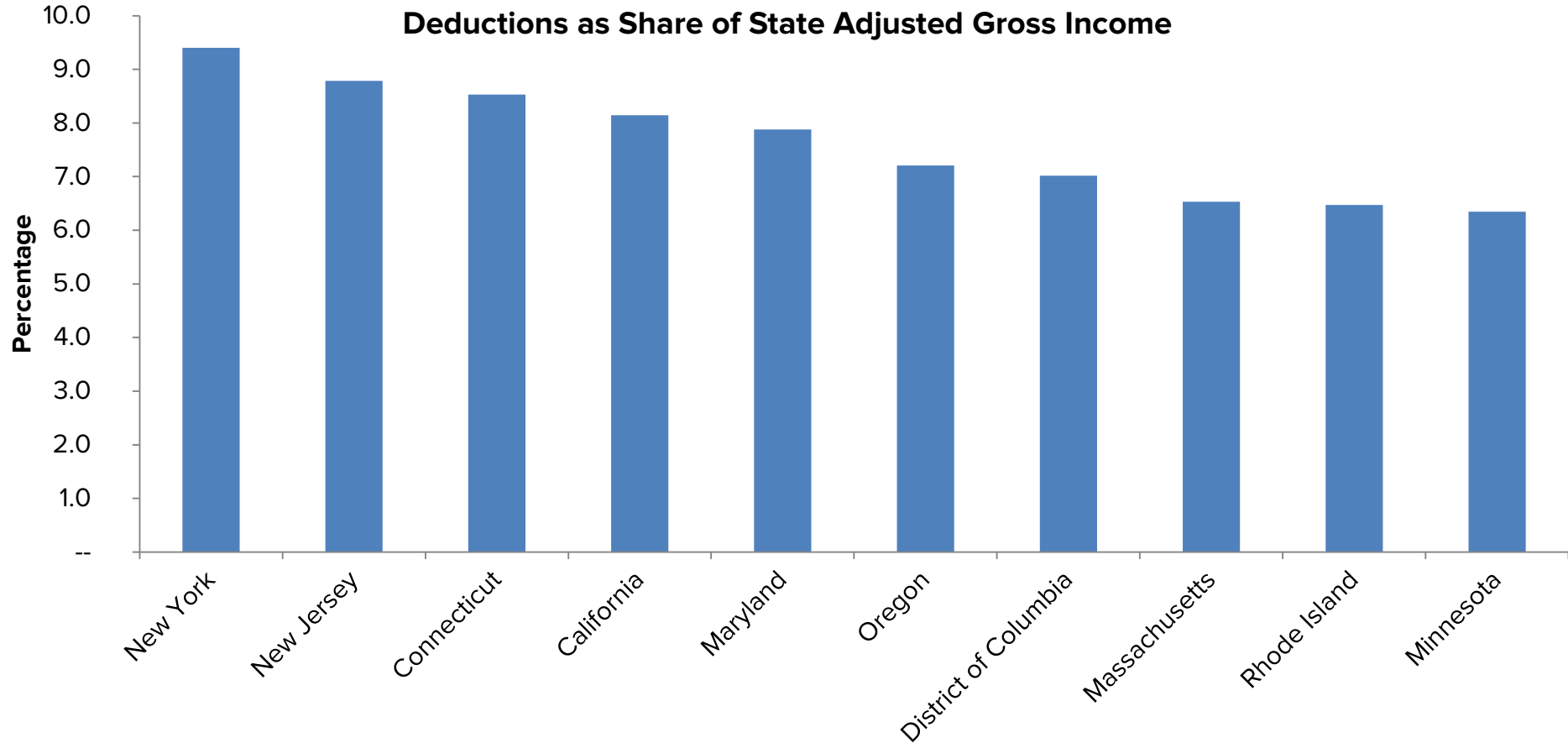


SALT DEDUCTIONS, 2015

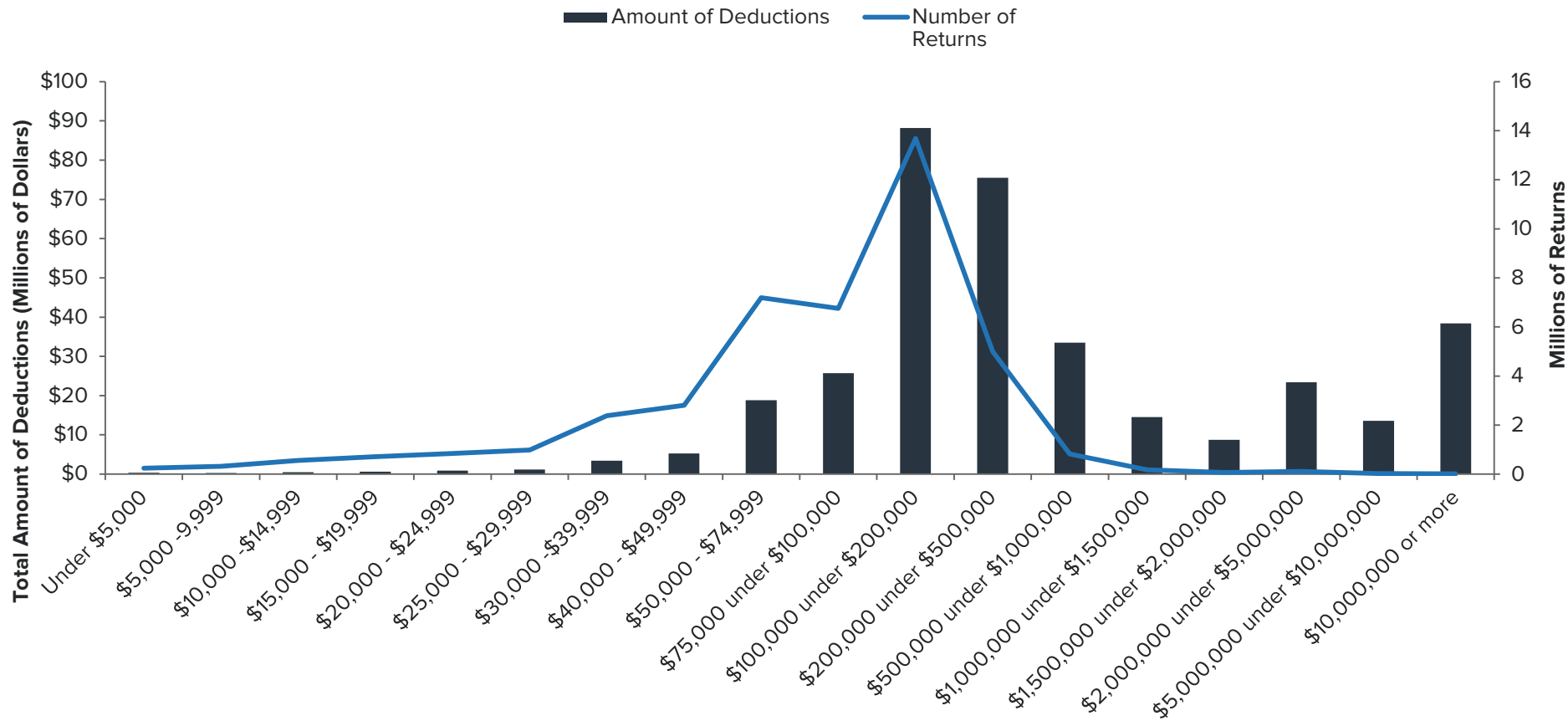
Total Deductions for State and Local Taxes - Top 10 States, 2015



SALT DEDUCTIONS, 2015



SALT DEDUCTIONS BY INCOME, 2015



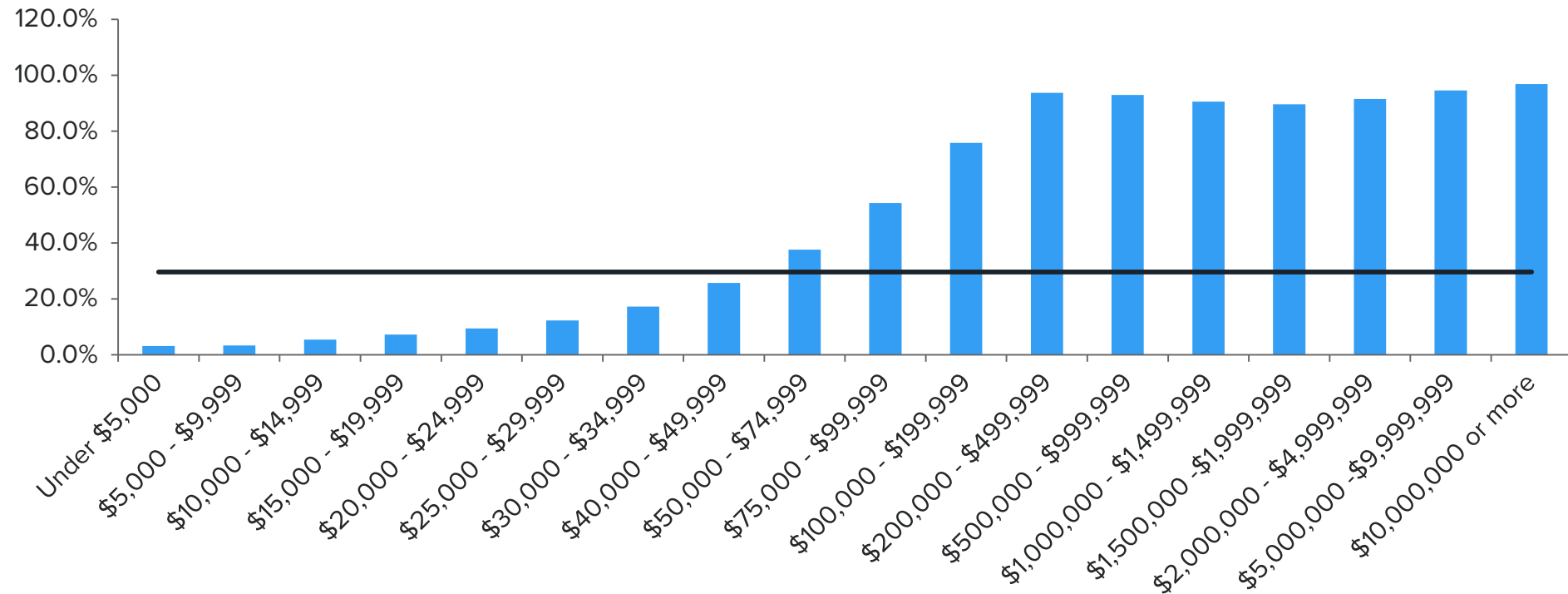
INCREASED STANDARD DEDUCTION

- Increased to \$24K (MFJ); \$12K (Single)
- Creates zero bracket for more low income tax payers
- Diminishes value of remaining itemized deductions

INCREASED STANDARD DEDUCTION

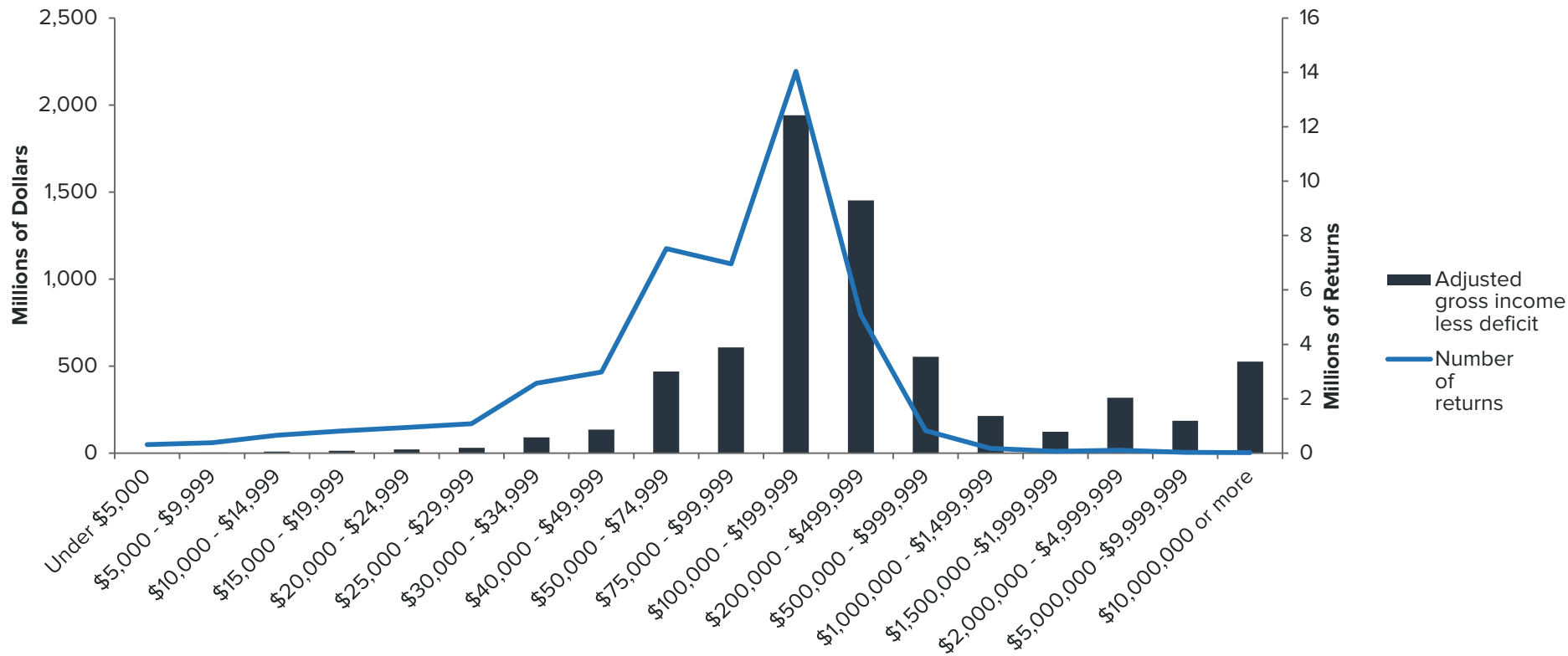
INCREASED STANDARD DEDUCTION WILL AFFECT LOWER BRACKETS

■ Percent Returns Itemized — Percent All Returns Itemized



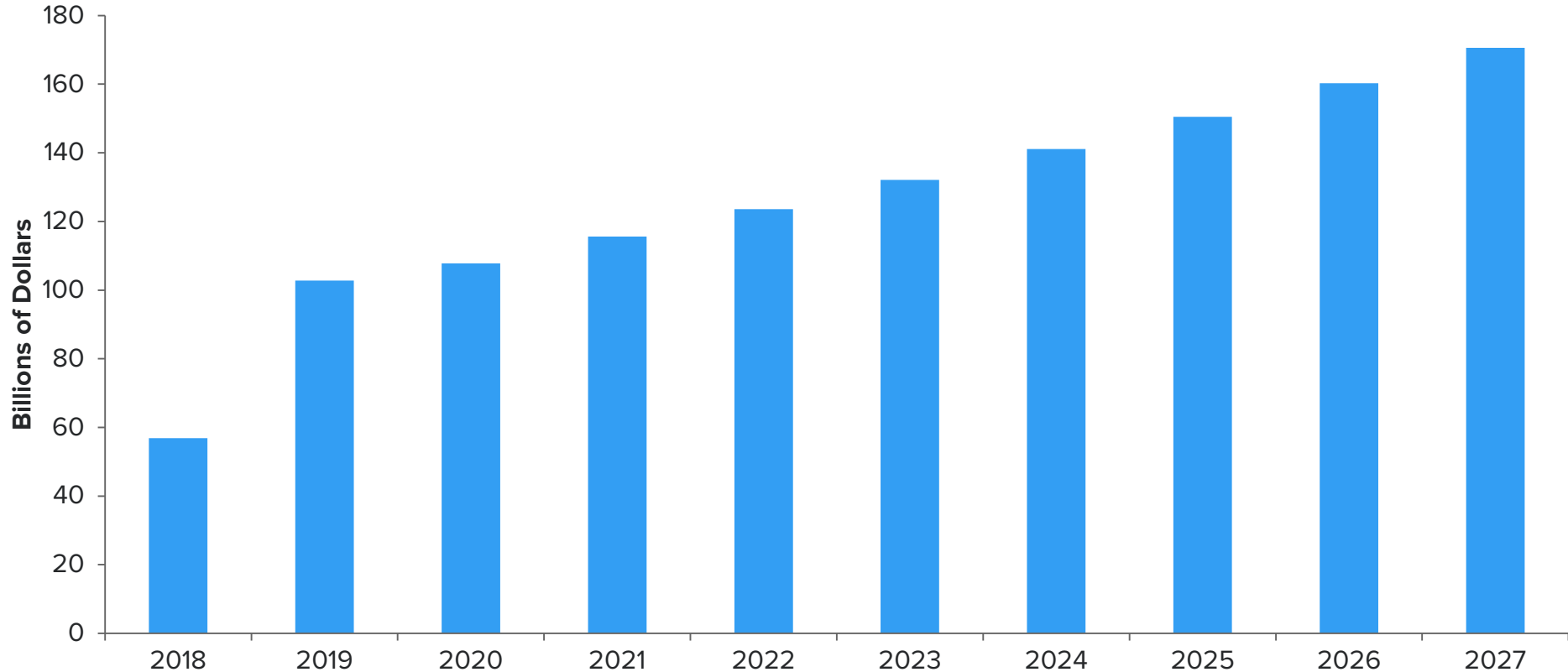
INCREASED STANDARD DEDUCTION

INCREASED STANDARD DEDUCTION WILL AFFECT LOWER BRACKETS



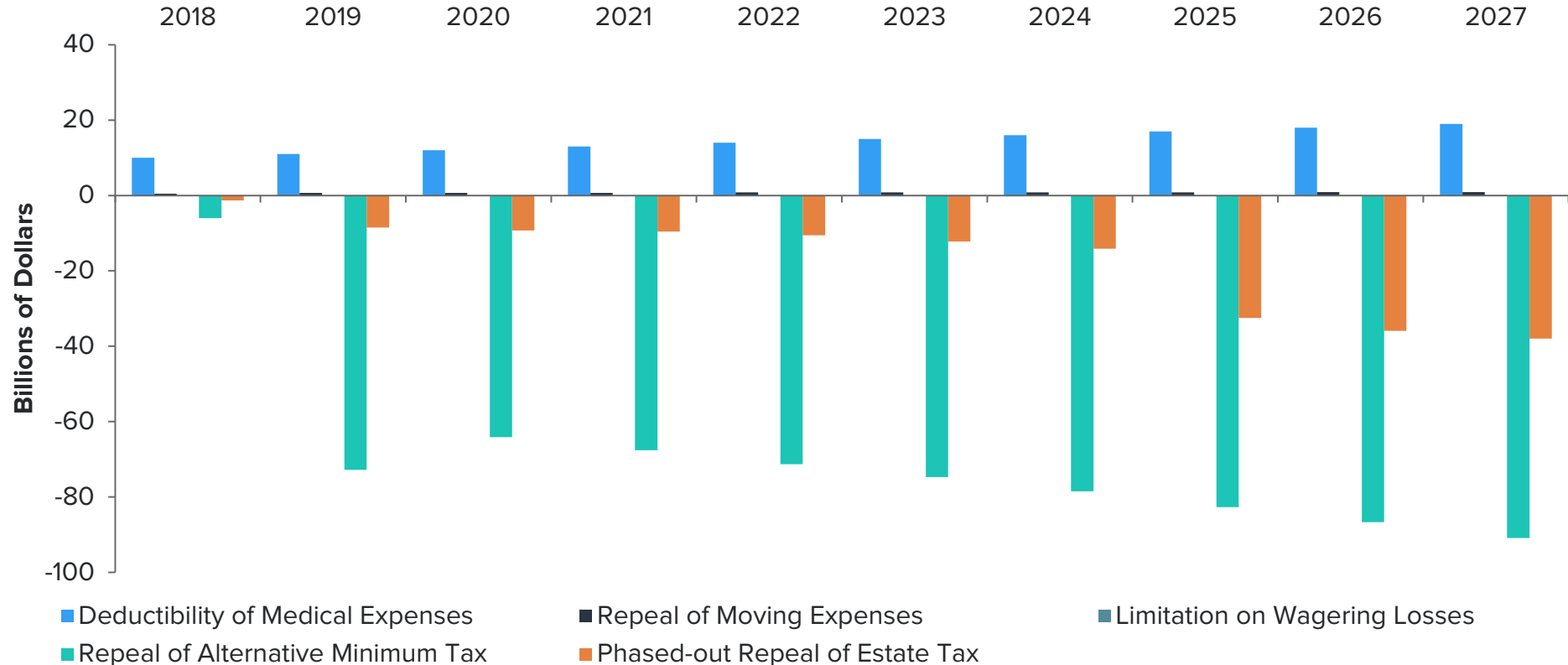
CHANGES IN FEDERAL REVENUES

DUE TO REPEAL OF ITEMIZED DEDUCTIONS



INDIVIDUAL RATE: OTHER CHANGES

MEDICAL EXPENSES, GAMBLING, MOVING, AMT, ESTATE



BUSINESS DEDUCTIONS & CREDITS

PROVISION	CURRENT LAW	BIG SIX PROPOSAL	HOUSE WAYS AND MEANS BILL	ANTICIPATED SENATE BILL
Cost Recovery	Expensing at 50% for 2017, 40% for 2018, 30% in 2019; \$500K threshold and phase-out at \$2MM	5 year allowance for 100% expensing of capital investments	5 year allowance for 100% expensing of capital investments; Section 179 expensing threshold increased to \$5MM and phase-out to \$20MM	5 year allowance for 100% expensing of capital investments; Section 179 expensing threshold increased to \$5MM and phase-out to \$20MM
Business Interest	Fully deductible, subject to certain limitations	“Limit”	All businesses > \$25MM subject to a disallowance of net interest over 30% of ATI	All businesses > \$25MM subject to a disallowance of net interest over 30% of ATI
Repatriation	No special rate	Two-tier system, no rates specified	Tax holiday at 12% for 8 years, liquidation at 5%, and moves to a territorial system	Tax holiday at 12% for 8 years, liquidation at 5%, and moves to a territorial system
Other Significant Changes		Retain research credit, low-income housing credit	NOL deduction; domestic production; clinical trials, entertainment expense; bonds	NOL deduction; domestic production; clinical trials, entertainment expense; bonds



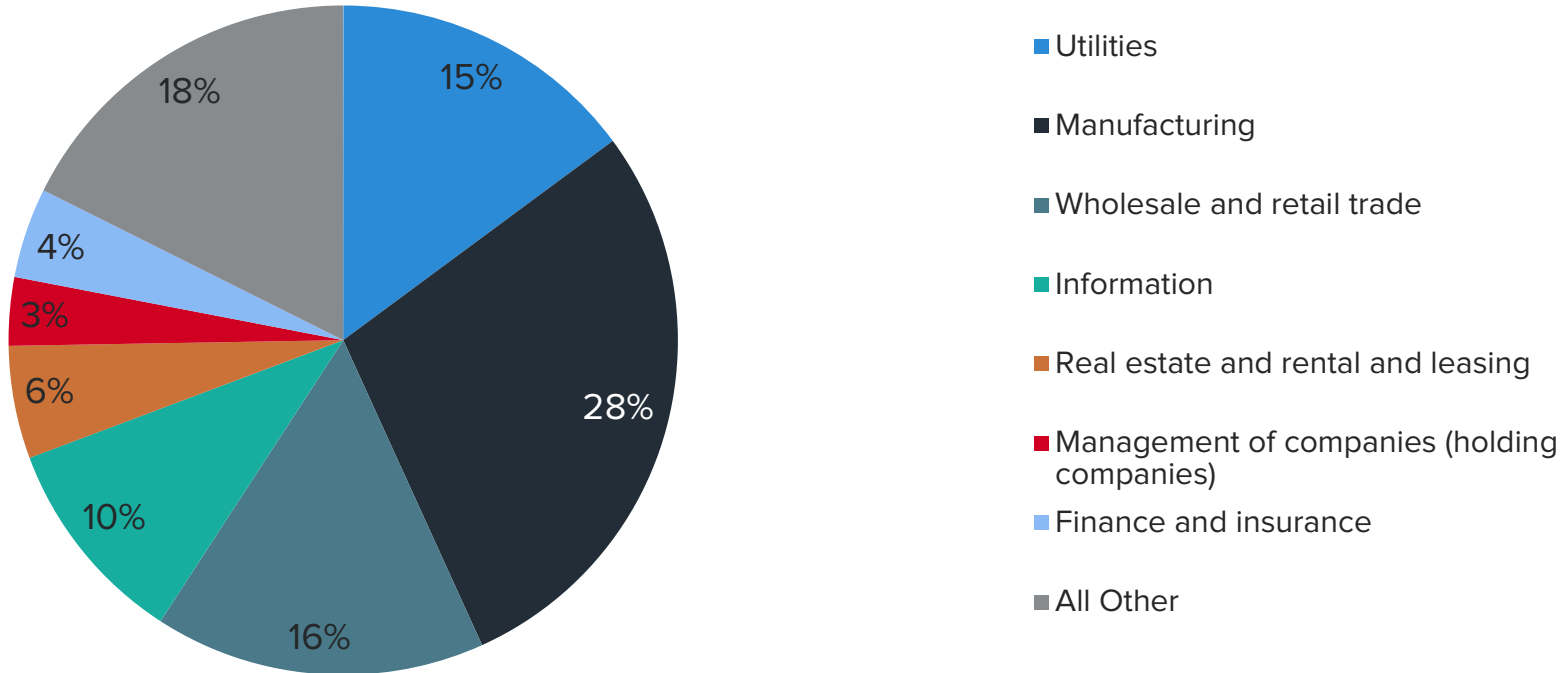
BUSINESS DEDUCTIONS & CREDITS

COST RECOVERY - EXPENSING

- Full and immediate expensing of equipment with life of 20 years or less under MACRS; certain software, currently subject of “additional depreciation”
- Applicable to equipment purchased between Sept. 27, 2017 and Jan. 1, 2023
- Triggered by taxpayers first use rather than equipment’s first use

COST RECOVERY: EXPENSING

SHARE OF DEDUCTION TAKEN BY INDUSTRY, 2013 (N=\$217B)

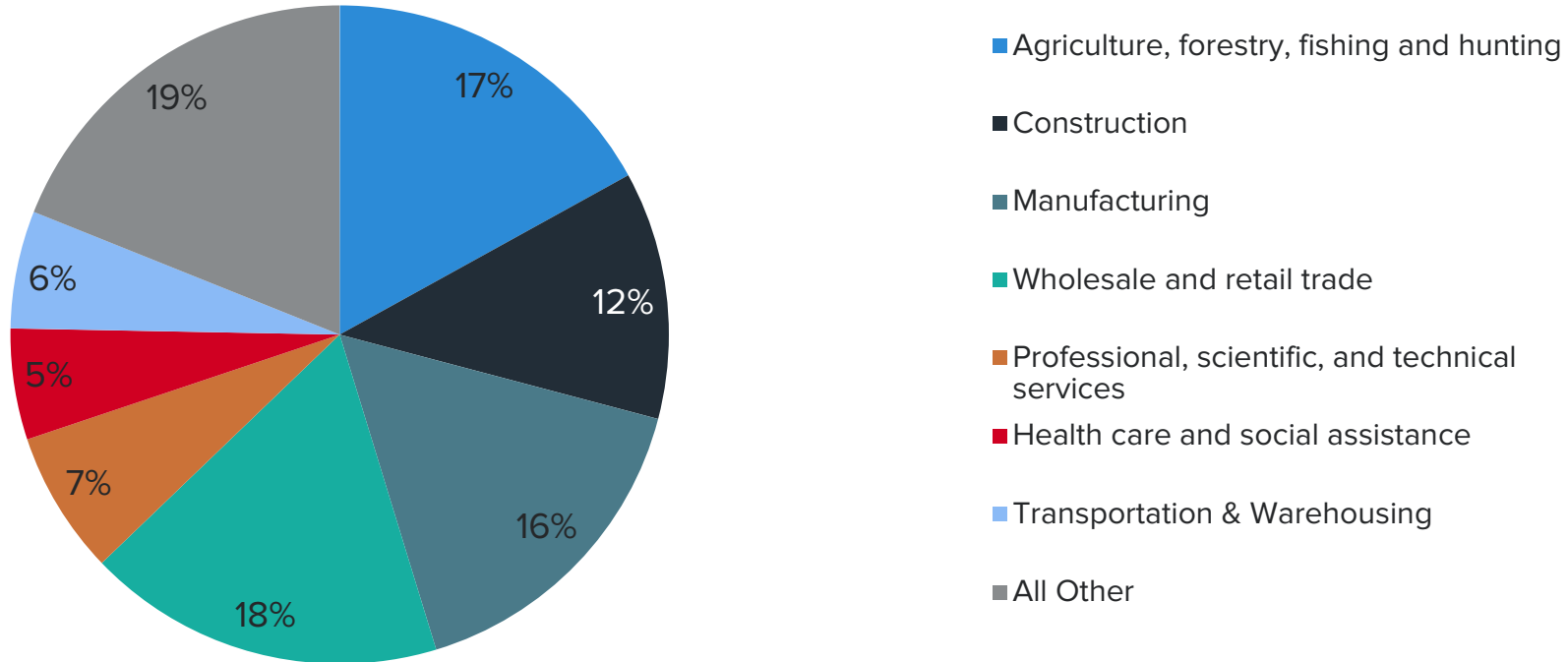


COST RECOVERY – SECTION 179

- Section 179 limitation increased from \$500K to \$2MM
- Phase-out amount increased from \$2MM to \$20MM
- Definition of Section 179 property expanded to include HVAC equipment

COST RECOVERY: SECTION 179

SHARE OF DEDUCTION TAKEN BY INDUSTRY, 2013 (N= \$13B)



COST RECOVERY – BUSINESS INTEREST

- Disallowance of deduction for net interest expense $>$ 30% of Adjusted Gross Income
- Amounts disallowed could be carried forward for 5 years
- Exemption for businesses with average gross receipts of \$25MM or less

COST RECOVERY – NET OPERATING LOSS

- Deduction of an NOL carryover or carryback only to 90% of taxable income
- All carryback repealed
- Effective for losses arising from tax years 2017 and later

LIMITATION ON DEDUCTION FDIC PREMIUMS

- Percentage of FDIC assessment would be non-deductible when total assets $> \$10B$
- Percentage determined by ratio of total assets $> \$10B$ bear to $\$40B$
- Assessments completely deductible for institutions $> \$50B$

OTHER PROVISIONS

- Full repeal of:
 - Deduction for domestic production activities
 - Business entertainment expenses
 - Credit of 50% of clinical testing expenses for certain drugs for rare diseases
 - Termination of private activity bonds and advance refunding bonds



REPATRIATION

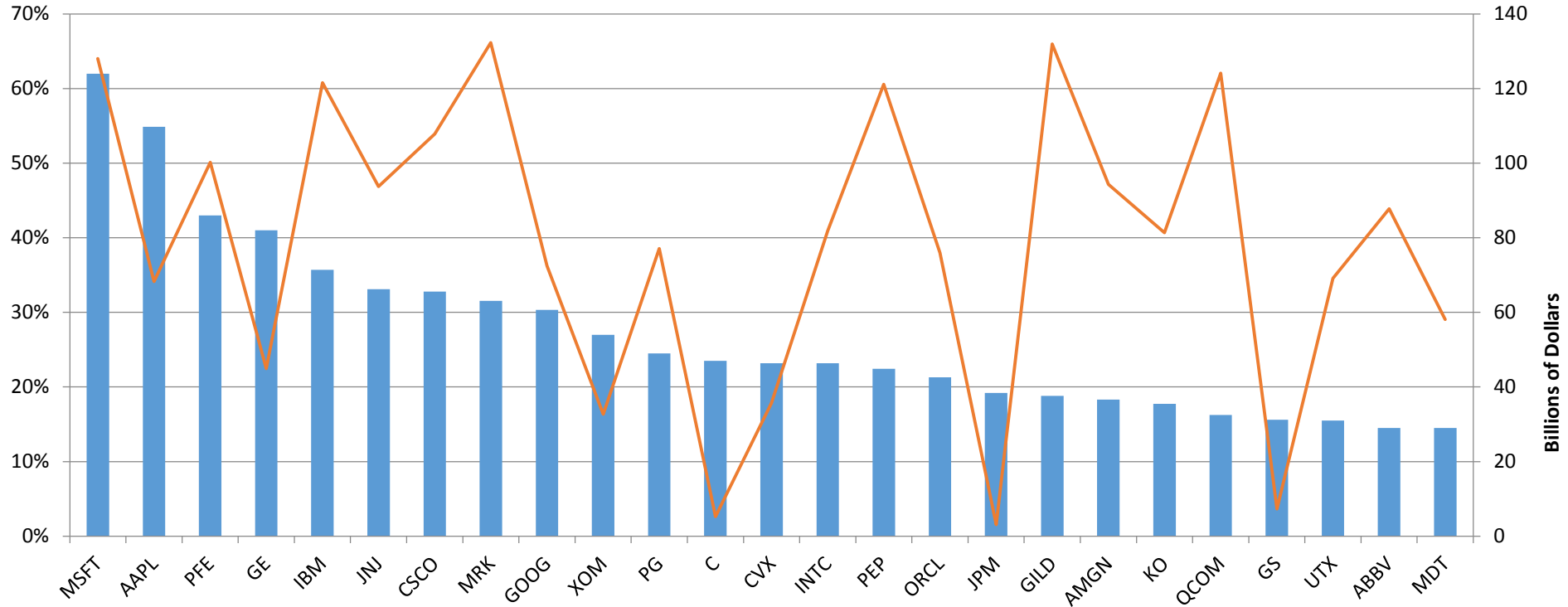
TAXATION OF FOREIGN INCOME

- All of dividends paid by foreign corporation to U.S. corporate shareholder would be exempt
- No foreign tax credits/deductions would be allowed
- U.S. tax on untaxed foreign sub earnings reinvested in U.S. would be repealed
- Two-tier repatriation

STRANDED FOREIGN INCOME

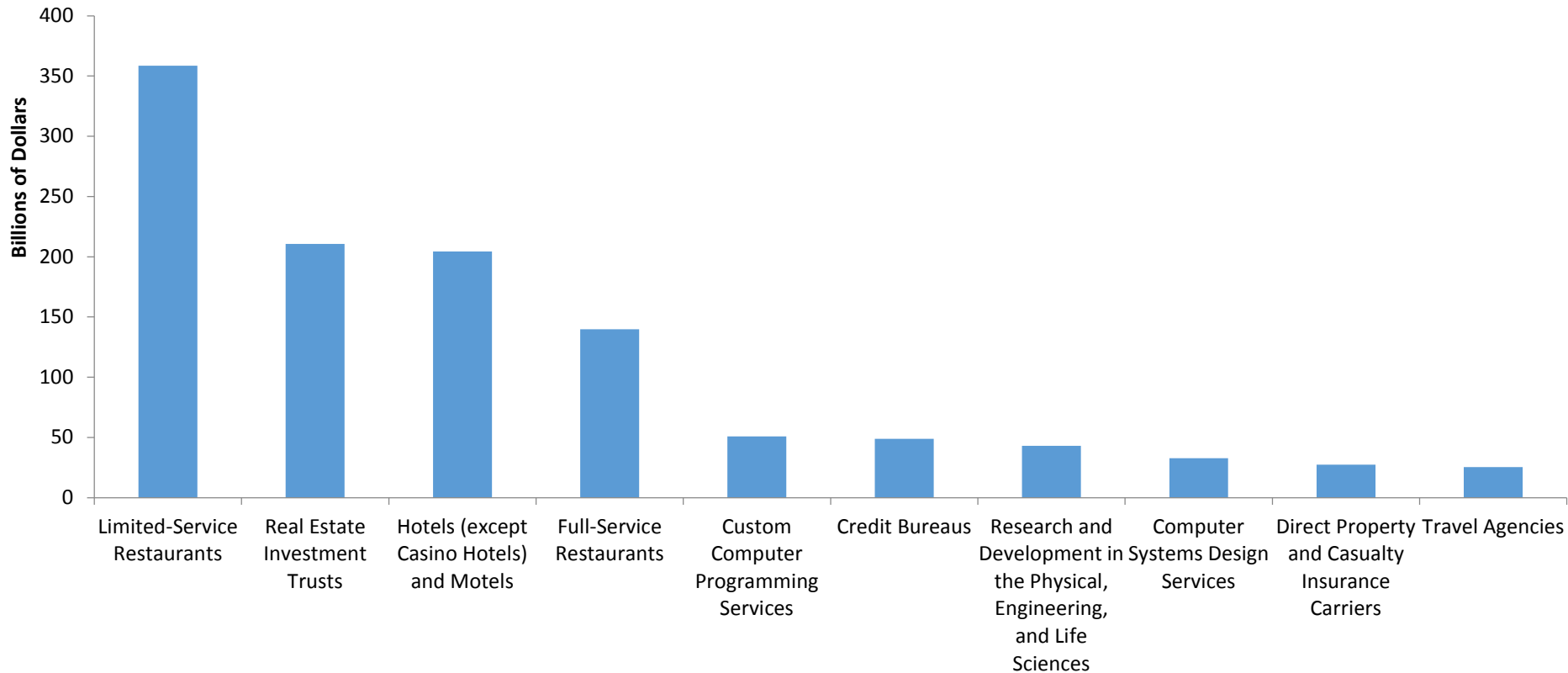
HALF OF \$2.6T IRFE HELD BY 25 COMPANIES, 2016

Indefinitely Reinvested Foreign Earnings IRFE as % of Total Assets



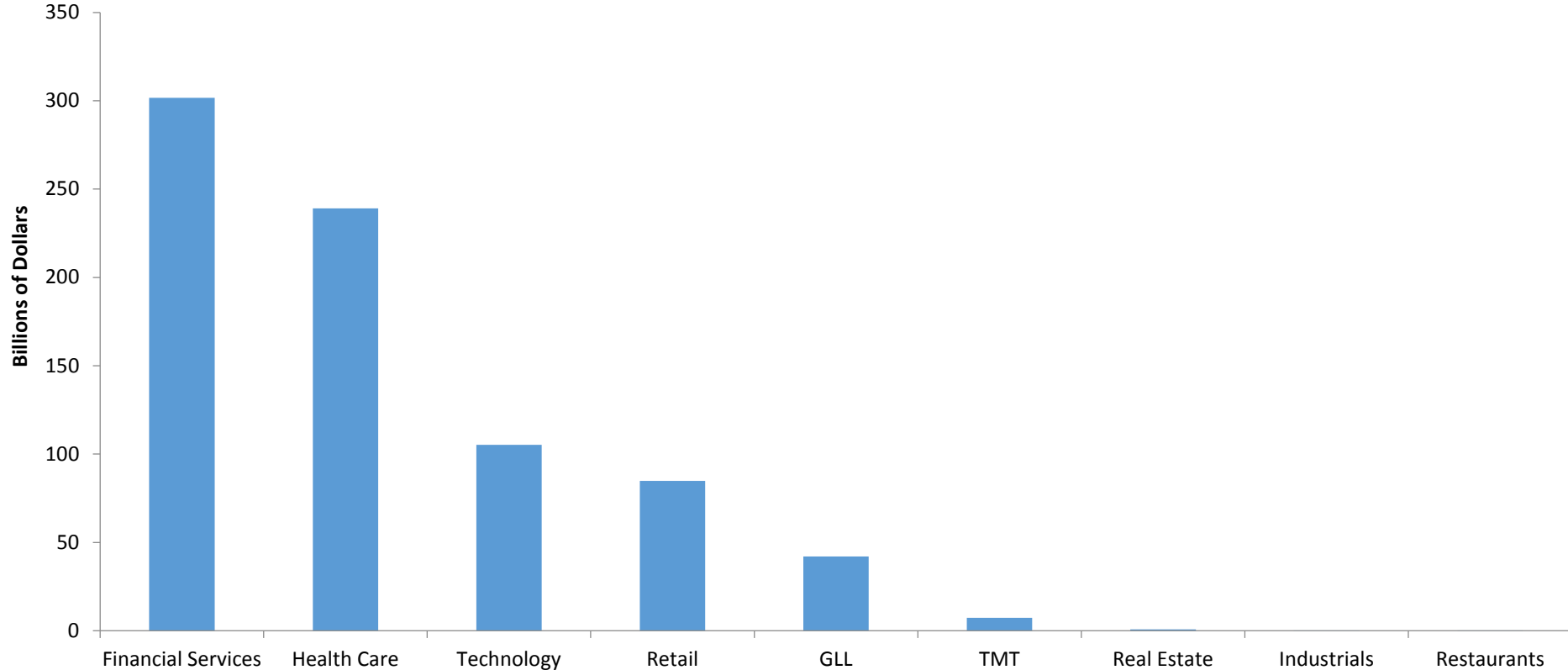
STRANDED FOREIGN EARNINGS

TOP TEN INDUSTRIES BY NAIC CODE, 2016



STRANDED FOREIGN INCOME

AGGREGATED IN MORE GENERAL CATEGORIES





SECTOR IMPACTS

SECTOR IMPACT: HOUSING

Short Catalysts

- **Mortgage interest deduction**
 - Applies only to interest paid on principal > \$500K on primary residency only
 - Home equity interest ineligible
- **Gains from sale of home exclusion**
 - Own and use home 5/8 prior years
 - Once every 5 years
 - Phases out for incomes above \$500K
- **Moving expenses deduction**
- **Partial repeal of SALT**
- **Increase in standard deduction**
- **Repeal of NOL carrybacks**

Long Catalysts

- **Lower individual tax rates**
- **Phased-in repeal of estate tax**
- **Repeal of rehabilitation credit**
- **Expensing**

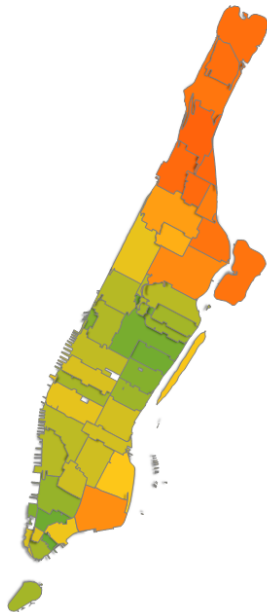
NYC → CONCENTRATED REDUCTION

THE LARGEST IMPACTS COME IN THE WEALTHIEST REGIONS

We have called out the areas with the largest SALT taxes as the areas with the greatest amount of risk.

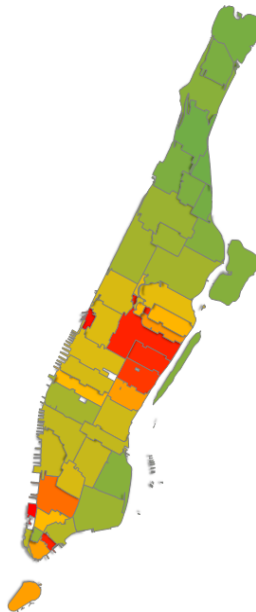
New York Adjusted Gross Income

Average Adjusted Gross Income
\$0 \$1,000,000



New York Percent Change in Take-Home Income

Percent Change to Take-Home Income
-18% -9% -1%



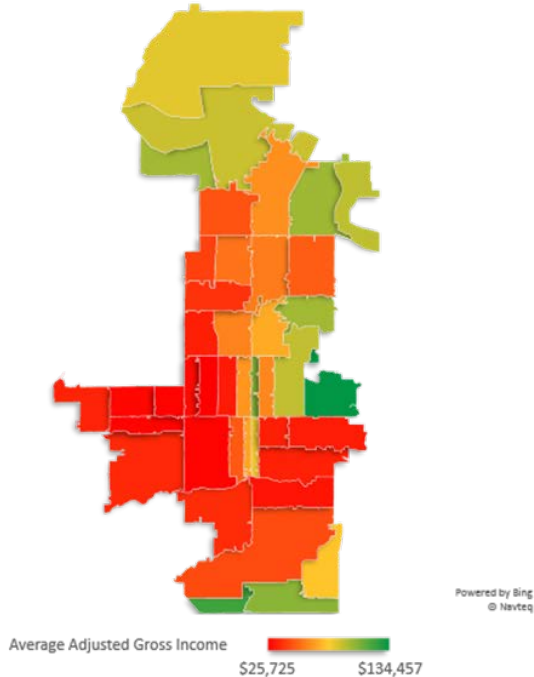
If we take that under the microscope and look at the impact across the zip codes, we see that the greatest impact is felt in the areas with the highest Gross Income, where those residents are most likely to take advantage of itemized deductions like SALT.

Note that in this case, all of NYC sees a negative impact under the proposal.

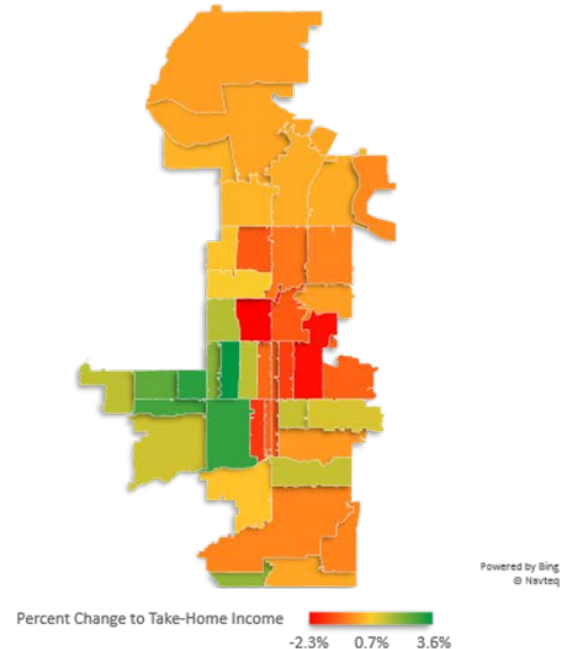
PHOENIX → LOWER INCOMES, AND FEWER ATTRACTIVE DEDUCTIONS

THE AVERAGE SALT TAX IN PHOENIX IS 12.6% OF NYC'S

Phoenix Average Gross Income



Phoenix Percent Change to Take-Home Income



Reiterating that theme, the Phoenix market is one that will reap some benefits from the proposed reform.

Combining lower State and Local Taxes, lower average Mortgage Interest, and lower Property Taxes with lower Average Adjusted Gross Income leads to Phoenix residents being net gainers under the House GOP's bill, seeing a +0.4% change to take-home income on the average

SECTOR IMPACT: HEALTH CARE

Short Catalysts

- Interest deduction cap of 30% AGI
- Repeal of medical expense deduction
- Repeal of 50% clinical trials credit for orphan drugs
- Tax on certain employee fringe benefits
- Repeal of special rule treating transfer of patent before commercialization as long term gain
- Repeal of Work Opportunity Credit
- Repeal of deduction on student loans

Long Catalysts

- Expensing
- Section 179
- Repatriation
- Lower corporate rate
- Pass-through rate reduction

SECTOR IMPACT: FINANCIAL SERVICES

Short Catalysts

- **Interest deduction cap at 30% AGI**
- **Mortgage interest deduction**
- **Gains from sale of home exclusion**
- **Bond reforms**
- **End of full deductibility of FDIC assessment for institutions over \$10B**
- **Repeal of rule permitting re-characterization of IRAs**
- **Repeal of deductibility of student loans**

Long Catalysts

- **Lower corporate tax rate**
- **Phased-in repeal of estate tax**
- **Expensing**
- **Repatriation**



POLITICAL PLAY

POLITICAL PLAY

- They have a lot of obstacles ahead. They only have 24 legislative days in Senate left before Christmas. They have a fiscal cliff on December 8th and they have the Alabama Senate Election on December 12th
- What does House leadership need to change for R's?
- Lobbyists are just as geared up as Congressional staff for this once in a generation reformation
- Trump
- Senate

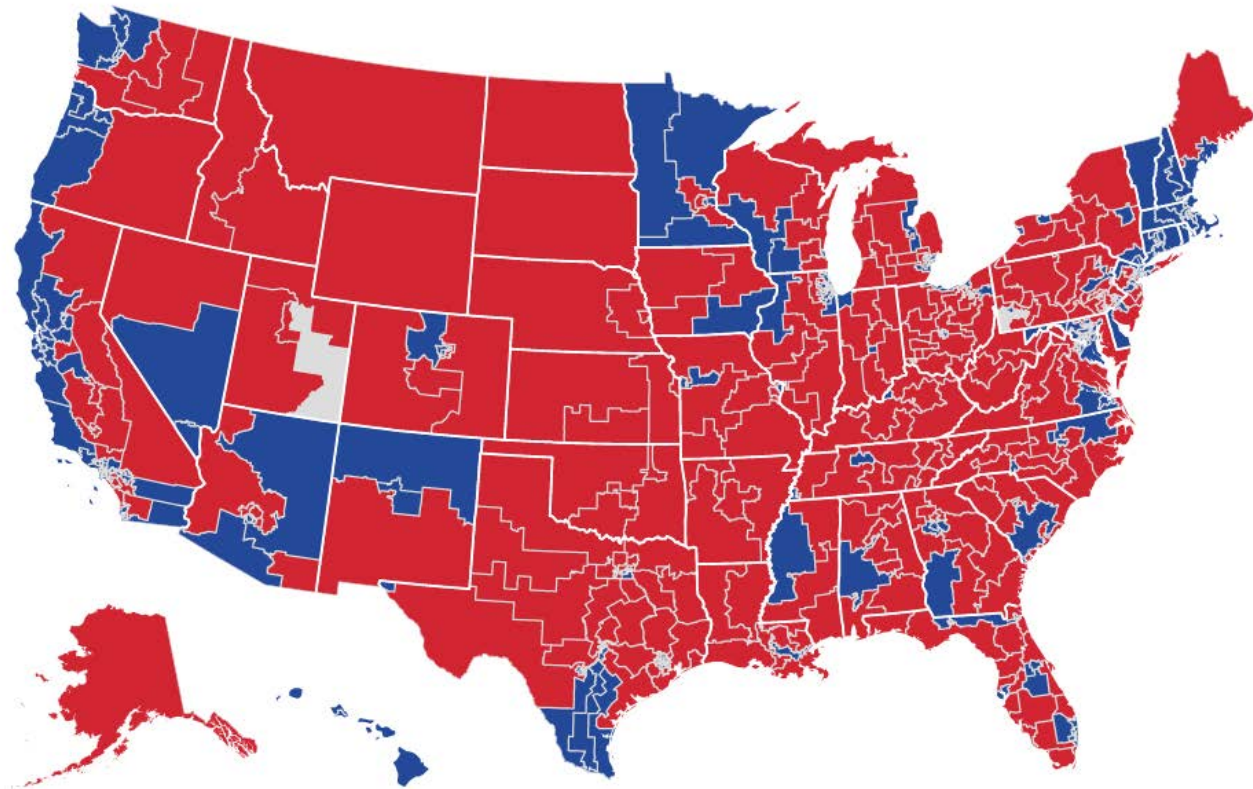
MIDTERMS

115th Congress – R's can only lose 21 seats in House and 2 in Senate

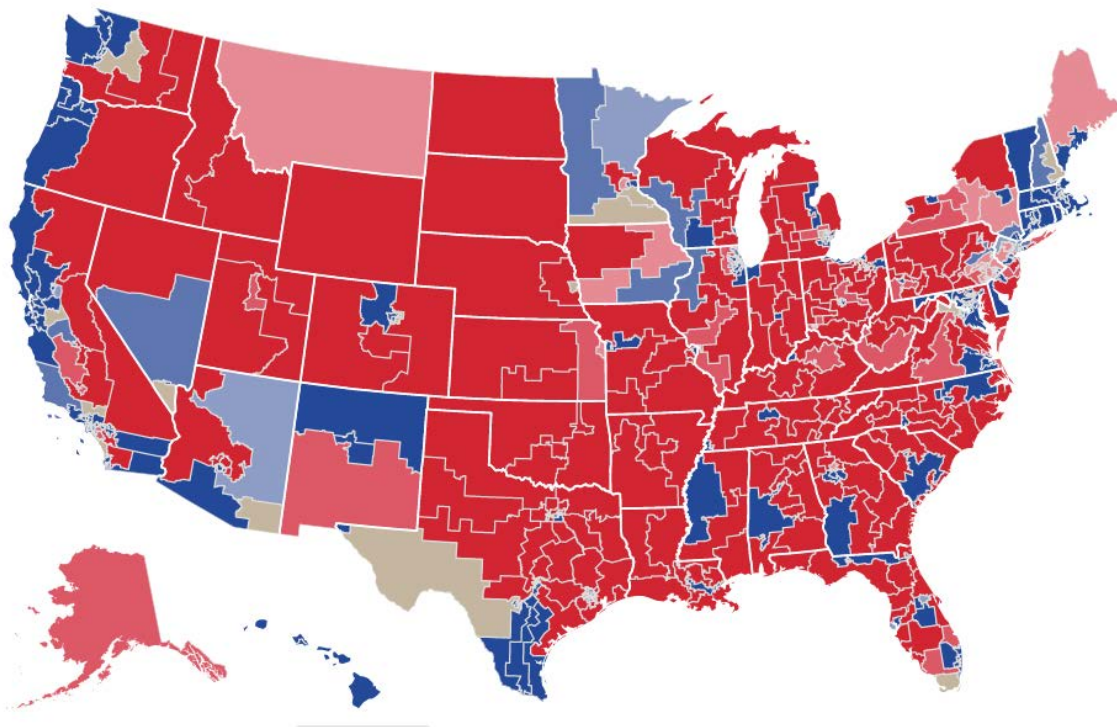
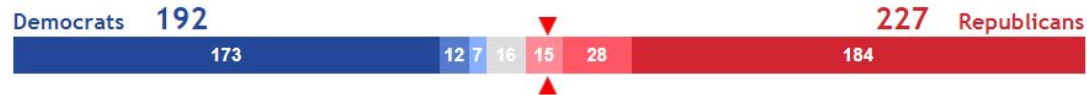
Historically controlling party loses ~33

If President's ratings are below 50% his party loses ~36

	Senate	House
Democrats	48	194
Republicans	52	239



MIDTERMS



House 2018 Races

- 173 solid D seats
- 184 solid R seats
- Competitive races shown

BATTLES

- House Republicans will be dealing with internal battles
- Vested interests will be trying to influence those decisions
- More changes and turbulence from Senate
- Will Dems jump in?

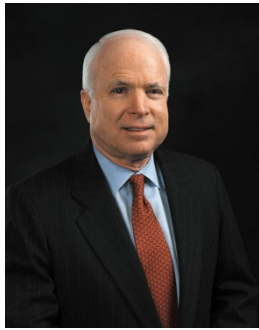
HOUSE W+M AMENDMENTS

- Limitation on Carried Interest
- Keeping deduction for health care expenses
- Investment Income (no reductions on dividends, capital gains, etc.)
- Worldwide Minimum Tax (that affects U.S. based multinationals)
- Lowering the proposed standard deduction
- Keeping some part of the personal deduction
- Increasing the child tax credit
- Continue deduction for student loans
- Continue deduction for personal casualty losses
- Continue adoption expense deduction
- Allow corporations to continue to deduct interest on loans
- Continue credit for clinical testing expenses for orphan diseases
- Continue work opportunity tax credit
- Continue tax credits for electric autos

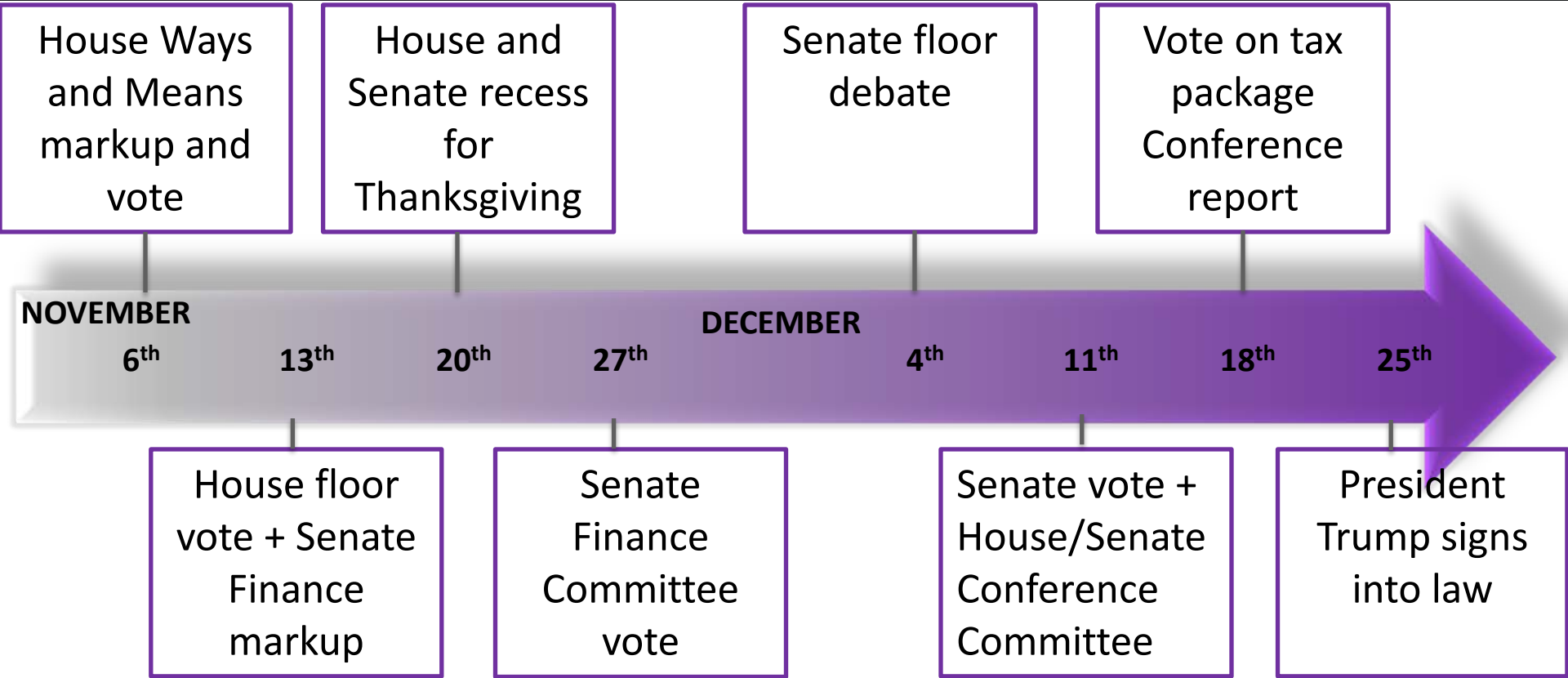
OTHERS IN THE CROSSHAIRS

- Carried Interest
- SALT
- Obamacare Taxes (including Individual Mandate)
- 401(k) Changes or Rothification
- LIFO and other sacred cows

SENATE



AGGRESSIVE TIMELINE FOR TAX REFORM



HICCUPS

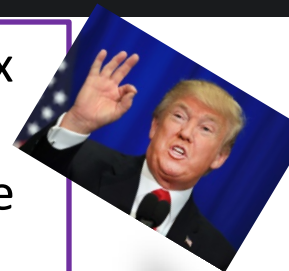


House Ways and Means markup and vote

House and Senate recess for Thanksgiving

Senate floor debate

Vote on tax package
Conference report



20 HOUSE DAYS

24 SENATE DAYS

DECEMBER 8th

NOVEMBER

DECEMBER

6th

13th

20th

27th

4th

11th

18th

25th

House floor vote + Senate Finance markup

Senate Finance Committee vote



Senate vote + House/Senate Conference Committee

President Trump signs into law

COMMITTEE TO VOTE EARLY



PLEASE SUBMIT QUESTIONS* TO

QA@HEDGEYE.COM

**ANSWERED AT THE END OF THE CALL*

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