Sankala Group

The Green Book

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In producing some 45+ quarterly letters since this firm was founded, I can't ever recall passing a government document along to clients verbatim. Well, times change, and the Biden administration's recent publication, which has been nicknamed the "**Green Book**", is worthy of a direct review. It pertains to the sweeping tax overhaul being proposed by the administration. Putting aside the probability it actually gets adopted by Congress (which is an important question I'll address below), I think it's critical for clients to know the core contents as many of the items will certainly re-appear over time no matter what happens before the next mid-term elections.

The beauty of this 114 page document, officially titled *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals,* is that the vast majority of what you need to know is actually laid out in the table of contents—which is only two (2) pages.

In fact, that table is so well done, you don't need to read any further to get a very clear view of the proposal. While there are a couple esoteric acronyms used in places, most items are quite straightforward. I reproduce those two pages below to provide the context for the remainder of the letter where I will offer more valuable opinion on how such provisions might impact clients and capital markets.

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Within the first section, *Reform Corporate Taxation*, the aim is to increase the corporate tax rate to 28% (currently 21%) while closing loopholes that foreign firms (and U.S. firms seeking to gain more favorable foreign tax treatment) are using to sidestep U.S. taxes. There is also a desire to create a 15% minimum corporate tax on the “book earnings” of large corporations. This would apply to firm’s earning $100 million or more per year and that are currently using an array of benefits in the IRS code to pay below the 15% rate, while still reporting significant profits to shareholders. Finally, there is the desire to allow a 10% tax incentive against the expense of brining jobs back to the U.S, and to disallow certain costs incurred during offshoring of jobs.

In aggregate, the impact of these items would fall primarily on the largest corporations and would especially apply to multi-national corporations. Much like the recent tax cuts put in place by the Trump administration, which drove equity prices higher by increasing cash available for payouts to shareholders, these increases will reduce cash available to shareholders. According to the research firm Strategas, the impacts of this section of the proposal are expected to reduce S&P 500 profits by $11.80 per share or 9.2% on current earnings of $128 per share. All other factors in equity valuation being equal, that would place considerable downward pressure on stock prices.

The second section, *Support Housing & Infrastructure*, focuses on the administration’s perception that the housing market is essentially a failed market these days. Demand is so high for housing in general that developers are not building enough housing that is attainable to lower paid workers or people on modest fixed incomes. Much housing that was attainable has been bought up by investors, and increasingly even single family homes are being bought for commercial rental. In short, the essence of the proposed solution here is the issuance of tax incentives that are attractive enough that developers will accept projects they would otherwise avoid in the current market to create that housing. Additionally, there are proposed Federal dollars to help states and municipalities issue infrastructure bonds to aid in required maintenance, refurbishment and upgrades of infrastructure.

Investment opportunities created by the housing tax credits are highly specialized and tend to be smaller private equity deals that require longer hold periods, lack liquidity, and are not appropriate for most investors. There are some publicly traded firms which work in this niche field and we are actively learning more about them.

Infrastructure, on the other hand, and the large bond deals that fund it, presents a lot of opportunity for investors. In fact, the challenge is the huge potential breadth. Infrastructure can impact concrete markets, steel markets, wire markets, water pipe, energy pipe, toll roads, engineering firms, construction firms and labor markets, among many others. Depending on the intensity of the development, it will also impact the bond and interest rate markets. Needless to say, it is a topic we are following despite its overwhelming nature. Our positioning here in Colorado makes us especially interested in water related infrastructure, and simultaneously the recent spike in inflation has made commodity markets more interesting to us.

Section 3, *Prioritize Clean Energy* is especially noteworthy for investors. To make a long story short, the proposal would dampen cash-flows at hydrocarbon firms, and increase cash-flows within the broad range of businesses working on cleaner power generation and transportation. Like infrastructure, this is a field unto itself and ranges all the way from Tesla to Exxon Mobile, and then back to smart grid technologies and carbon sequestration projects. Our firm has taken a unique interest in the nuclear power elements of the plan, which we perceive as under-analyzed and less “hot” and richly valued than other segments of this sector.

Existing nuclear power represents ~20% of the U.S. power supply, and about half (1/2) of the current total generation that doesn’t produce greenhouse gases. Presently, tax credits exist for new advanced nuclear facilities, but no credits are there for the existing facilities. Some of those plants are looking at potential early-retirement for purely economic reasons. The proposal would establish credits for existing facilities to ward off early plant retirements and the loss of this greenhouse gas free electricity. While these credits would only total $1 billion per year, this market is so small that downstream impacts could be very material. For example, we are following the global uranium markets closely and the avoidance of early retirement of U.S. plants is very significant given that only 440 exist worldwide with 55 under construction. Such a policy change would materially impact the market for fuel rods and uranium, which is also a very small and under-analyzed market. Additionally, unlike the highly followed stock of Tesla, this space is coming off an era of crisis and investor disillusionment, allowing us to potentially buy real current cash flows cheaply rather than paying up for the promise of cash flows in the distant future—which investors seem to take largely for granted these days.

Next, you have the *American Families Plan* section. This is perhaps the most impactful part of the proposal to clients.

First, it would lift the top bracket on personal taxes from 37% to 39.5% and also adjust the bracket itself down from current law levels to prior 2017 levels, which would thereafter be inflation adjusted annually.

Second, it would lift the capital gains rate for the super-high earning ($1m+ per year) from 23.8% to 40.8%. Fear of such a rate change would likely cause many major stockholders (founders, executives) to try to bring forward gains under the current regime by selling holdings which could materially impact the market for certain stocks.

Further, to make sure those higher rates are actually paid, it also proposes doing away with the “step-up” in cost basis at the death of an asset owner. This proposal would have material impact on many clients who hold highly appreciated stock and are planning to own it into death, to be exempted from the capital gains tax, and only subject to estate taxes. This common estate planning tax strategy would be negated if the “step-up” in cost basis is ended. This would have huge implications for how we manage non-IRA money for our clients. It also contains a range of new provisions that would usher certain LLCs, LPs, and other partnerships and trusts into capital gain realization events. It would create some exemptions for family-owned and operated businesses. I won’t get any deeper into this here because it is so specific and meaningful to each unique client, and it frankly would spawn the development of a new cottage industry inside the wealth and tax advice professions just to deal with all the administration that would be involved. If I were to guess at a single part of the proposal that stood the least chance of actual adoption, it would be this section. The administrative burdens it would create, and the upended lifelong investing and business building strategies it would nullify simply won’t turn out to be very popular on either side of the aisle. The administration has attempted to navigate the obvious problems as gracefully as possible, but the solutions are so complex, most powerful political constituents will get such a headache just reading them (let alone practicing them), they might oppose on those grounds alone.

The proposal also plans to reduce the differences in taxation between S-Corp and LLC companies. These changes are very interesting to anyone who owns either type of firm, including our own, but are beyond the scope of this letter and must be left to private discussion with such owners. In short, they would converge in their tax treatment and offer less discretion as to what is employee compensation and what is a dividend or profit distribution.

There are also proposed changes to the Affordable Care Act (ACA), aka Obamacare, but the acronyms and decimal percentages are too complex to parse:

Applicable Contribution Percentages for 2021[1]

Percent of FPL	ARP[2]	Pre-ARP[3]
Up to 133%	0%	2%
133% up to 150%	0%	3%-4%
150% up to 200%	0%-2%	4%-6.3%
200% up to 250%	2%-4%	6.3%-8.05%
250% up to 300%	4%-6%	8.05%-9.5%
300% up to 400%	6%-8.5%	9.5%
400%+	8.5%	Not Eligible

[1] Required contributions increase incrementally between income breaks.
[2] These percentages also apply in 2022.
[3] Pre-ARP applicable contribution percentages have been indexed beginning in 2015. These are the percentages for 2021.

My basic reading suggests the following in practice—we will all keep earning what we are able to earn, and we will all keep buying the same health insurance we plan to buy if not already provided by an employer. But something is going to change in the software that your CPA and

TurboTax uses, and hopefully they have talented programmers because it doesn't look easy. I expect this table to be one of those things that leaves us wondering each year, "How does TurboTax possibly have new software updates even on April 14th?"

The childcare tax credit related proposals are very favorable to people with families, and would essentially put material cash into their pockets. Some of it won't be relevant to our clients due to income limits, but the Child Tax Credit (CTC) expansion proposed will more broadly benefit parents, even wealthier parents. Again, this is more of a CPA issue, but we are actively thinking about what private businesses might benefit downstream. Readers, if you have any strong feelings about what the average parent will do differently with an extra $1,000 to $1,600 in their pockets per year, per child, please let us know. Such a policy could, however, help the United States recover from the 4% decline in births seen in 2020, which apparently some see as a material economic problem.

Next up is the section called *Closing Loopholes.* Personally, I'm delighted to see these measures in the Green Book. Essentially, this part of the proposal would prevent hedge fund and private equity managers from claiming capital gains treatment on money that is clearly part of their earned income from managing money. It is a well known loophole that mysteriously (or not mysteriously) has never garnered the political will to get closed. Our firm doesn't get paid this way, and this strange provision only benefits the extremely fortunate who do not need this benefit. Are there opportunities here? Yes. If it looks like this can ever clear Congress we can try to be some of the first ones taking serious bets against publicly traded hedge fund and private equity firms, especially the mediocre ones that justify their existence based on this loophole. We won't be the first to make such bets, but we may not need to be given how critical the loophole has been to such firm's ability to attract talent and generate after-tax profits.

This same section would also end IRC Section 1031 Exchanges that allow commercial property owners to sell properties and avoid capital gains tax if they reinvest those funds into new commercial property. Most analysts are unsure what the original rationale for this code was. Certainly if we own shares of Google, we can't sell them, and provided we buy some Microsoft with the proceeds, avoid capital gains tax. It seems to boil down to fairness across asset classes. Are there actionable investment ideas here? Not really so much in the public markets. It will end a smaller cottage industry, and it might reduce turnover for commercial property brokers, but largely it would simply result in taxes being paid when commercial property is sold just like other assets.

The last loophole relates to what the IRS calls Excess Business Loss limitation. This proposal would permanently limit individual taxpayer's ability to claim exceptional business losses against income of other types such as capital gains. It's a bit esoteric, but in short it would make the treatment of business losses the same for both corporate and individual taxpayers. Pointedly, the loophole is currently shut until 2027. This would simply lock the door closed thereafter. There are not great investment strategy implications here because it applies to private business formats (LPs and LLCs) and not corporate taxpayers.

After laying out a new set of rules, it makes sense to say how they will be enforced. This is the section called *Improve Compliance.* Grover Norquist will be very disappointed. He helped build a strategy in the eighties under Ronald Regan which was called “Starve the Beast.” It is actually as simple as it sounds. The idea was that if your goal is to shrink the government and prevent it from spending more money, you need to cut off its income. This would be best achieved by cutting taxes and reducing funding to the IRS. The Green Book isn’t keen on that philosophy. Since the IRS’s operating budget fell 20% over the last decade, the administration wants to back fill the reduction and provide $417 million in 2022, or $6.7 billion over the full the 10 year budget window specifically for compliance and enforcement. In short, more taxpayers, and especially the wealthier ones making $400k plus per year, would be audited more often.

Additionally, the administration proposes a new reporting requirement for banks and other financial institutions including crypto brokers. In essence, they want banks and brokers to file an informational return to the IRS showing gross inflows, outflows, a breakdown for physical cash, all transactions with foreign accounts, and transfers between the same account owner to other accounts. It would apply to all bank, loan, and investment accounts over $600.

This appears to be the broadest reach for financial information on taxpayer’s accounts in the government’s history. It’s easy to see that such a requirement may be a stepping stone for an eventual wealth tax—a tax based on what one has, rather than on what one earned. Certainly it is something more Americans, not just investors, should be aware is in the current Green Book. Are there any direct investment implications? That is harder to see at this early stage, but presumably it would require a great deal of funding at the IRS to read or parse the information, and much more time and resources for banks to produce. Certainly, the authors of the 1980 *Paperwork Reduction Act* (my personal favorite piece of U.S. legislation) would not be enthusiastic about it. Net on net, it would make banking even more costly after a decade of increased regulation, perhaps leading to more weakness and continued low valuations in the financial sector.

In the final section, *Improve Tax Administration*, you largely have some less interesting proposals that don’t seem worth detailing to clients, excepting one serious one, and one pretty humorous one. First, the crackdown on crypto assets is real. The Biden administration wants information from crypto brokers (no surprise) and wallet hosts (big surprise) on par with stock and bond brokers. Second, the administration has finally had enough of your chicken-scratch. If you make more than $400k per year, or you’re filing a business or partnership with 10 or more shareholders and partners, you're going to be required to eFile. They've seen enough of your blue pen and bad handwriting—and they are officially over it!

Will these proposals pass?

In the current Senate this type of legislation seems very unlikely to get passed. However, many rational people, myself included, see some ideas here that make good fundamental sense. But picking out what makes sense and what doesn't make as much sense, is not really how Congress seems to work in practice. On this issue, tax, it often boils down to sheer political power rather than reasoned nuance.

In the next mid-terms there will be quite a bit on the line for tax reform. All investors will be watching very closely. Certainly our firm can adapt to any and all of these changes, and rather than feeling anxious about it, we will enthusiastically look for the new opportunities that any viable bill will present.

I do see some risk that if the mid-terms are won materially by the Democrats, the Green Book might grow a few shades greener for government coffers. Remember, this proposal is being presented during a period of time with a well-known divided Senate. These proposals could see a lot more added if the political path was cleared.

What I can say confidently is that some of these ideas are not going away. That is simply due to the fact that the average American is more aware of preferential treatment in the tax code than ever before. Certainly the recent ProPublica story on tax avoidance among billionaires was widely circulated and found interested readers on both sides of the aisle. We are wise to start thinking about this and forming action plans to utilize under a range of different outcomes. Preparation and planning are certainly more advantageous than reaction. Most things we would do for client investments involve taking action prior to the final legal implementation. This is true both for new investments we might make, or changes to existing investments in preparation for new tax treatment.

While we are staying apprised of developments in the Green Book, you may find me doing a little day dreaming about my own solution.

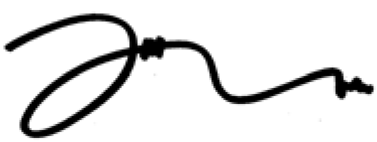
I call it *One Dollar, One Tax*. It really does fit on the proverbial "post card." It treats all people fairly and equally. It even eliminates all "credits" while simultaneously creating a *Bureau of Congressional Largesse* through which Congress can practice its economic wisdom without making you answer a thousand non-relevant questions. It even files via free software provided by the IRS itself! I mean, they are the ones who write the tax code, and they have all your W2s, K1s and 1099s already on file, right?

And then I startle awake. This isn't Sweden. Back in reality, Congress actually did agree on something recently and they passed some new tax legislation. It was ironically named the *Taxpayer First Act* of 2019—and it stopped the IRS mid-stream from working on exactly such a free filing service of its own. Turns out the tax software lobbyists can't be put on hold down at the *Bureau of Congressional Largesse.* They even get to help name bills the opposite of their contents!

While I recount that sad day in Congress in jest, my conclusions are real. Congress's inability to set aside undue influence prevents a lot of positive things from being done for taxpayers. That's why the "carried interest" loophole has survived numerous administrations. Lowering taxes garners far more support from entrenched corporate players than raising taxes does—and both parties rely on such entrenched players in their own way.

To conclude, I see a high likelihood of tax complexity rising further. The probability of some loopholes getting closed is more moderate, and the odds of changes to core elements of the capital gains tax is fairly low.

Yours truly in death and taxes,



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