GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Cutting US Corporate Tax Rates – The Biggest Winners Are Likely To Be Shareholders!

In this US electoral season the issue of corporate tax reform comes up frequently. Both parties seem to understand the competitive disadvantage in which US corporations find themselves often due to much more generous tax policies in other countries.

In recent years tax inversions have become much more prevalent as a way to, in a sense, arbitrage national tax systems. Tax inversions typically involve two companies domiciled in separate geographic locations entering a merger agreement and moving their tax jurisdiction to that location possessing the lower effective tax rate.

Needless to say tax inversions are incredibly unpopular among tax authorities and politicians have taken up the fight. In the US new regulations were put into effect by the Treasury Department in April of this year making corporate inversions more difficult and expensive to bring about.

Another incredibly unpopular manifestation of "tax arbitrage" involves the hoarding of cash by US corporations in low tax offshore locales. In a recent CNBC article it is estimated that cash held offshore by US corporations now tops $2.5 trillion. Given the large corporate tax differential between the US and locations where the cash is commonly held such as Ireland it is unlikely that US corporations will ever repatriate the cash. Various "tax holiday" measures have been proposed but to date there appears to be a standoff at least until the new US President is elected.

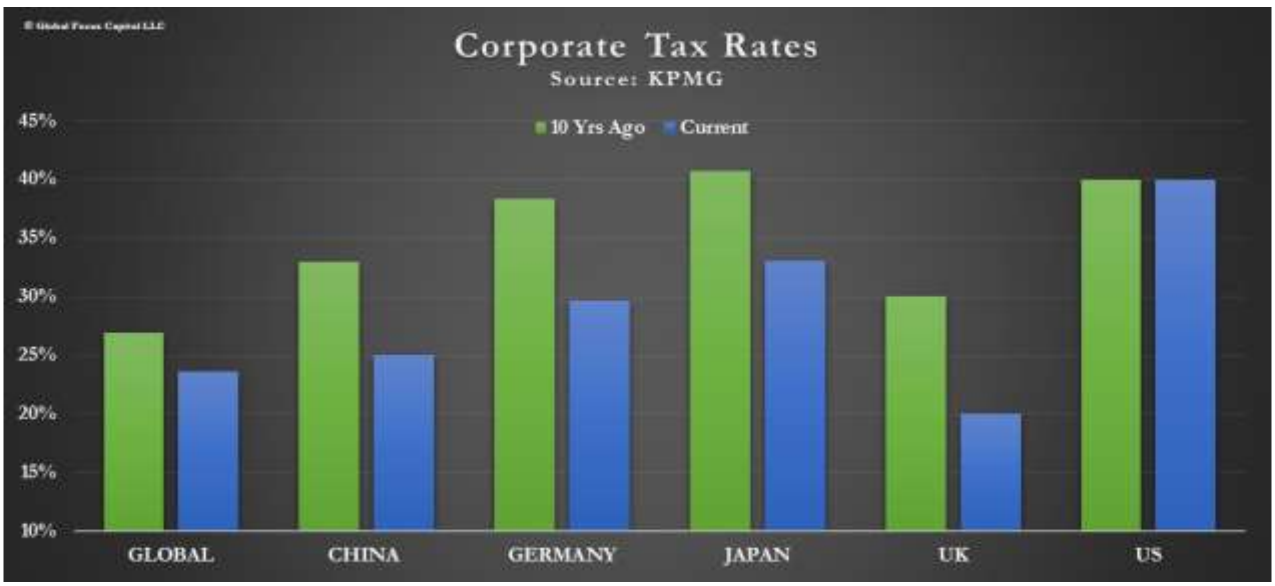
While the actions of the US Treasury will discourage some US corporations from pursuing mergers purely as a way to lower their effective tax bills and a "tax holiday" is very likely the practice of tax arbitrage is unlikely to diminish unless US corporate tax rates are significantly lowered

Where does the US stand in terms of corporate tax rates? KPMG, the large accounting firm, provides an excellent guide to Global Corporate Tax Rates . The current corporate tax rate for US domiciled companies is shown as 40% which is composed of the top federal rate of 35% plus applicable state and local authority taxes. The KPMG guide is meant as a guide but clearly the ultimate corporate tax rate faced by companies is a function of many variables including importantly the location of foreign subsidiaries.

According to the KPMG data the US ranks highest in terms of corporate tax rates among major industrialized nations. The global average in the KPMG sample is 23.6% with rates in OECD countries slightly higher at 24.8%.

In the last ten years there has been a race to the bottom in terms of corporate tax rates. Countries have been lowering their tax rates as an incentive for companies to relocate to their jurisdictions. In the KPMG sample we find seven countries with a zero corporate tax rate. Some well-known tax locales with no corporate taxes include Bahamas, Bermuda, Guernsey and the Isle of Man.

As mentioned before we find a steady downtrend in tax burdens in most countries except for the US. The chart below shows tax rates for the 5 largest countries in the world by GDP as of 2016 as well as ten years ago. The global average has dropped nearly 4% over this time period.



Japan had been typically thought of as a high corporate tax country but reforms starting in 2012 have gradually reduced rates down to 32%. China has seen tax rates drop by 8%. Germany has dropped tax rates by 8.6%. Similarly corporate tax rates in the UK are 10% lower than ten years ago. There has been no similar response from the US tax authorities and all-in tax rates have held firm at 40% over this time period.

What tax rates do corporations actually pay given the expanding scope of their offshore activities?

After all if Apple did not have a global footprint it would be unlikely that an estimated $200 billion in cash is held by its foreign subsidiaries to take advantage of lower tax rates.

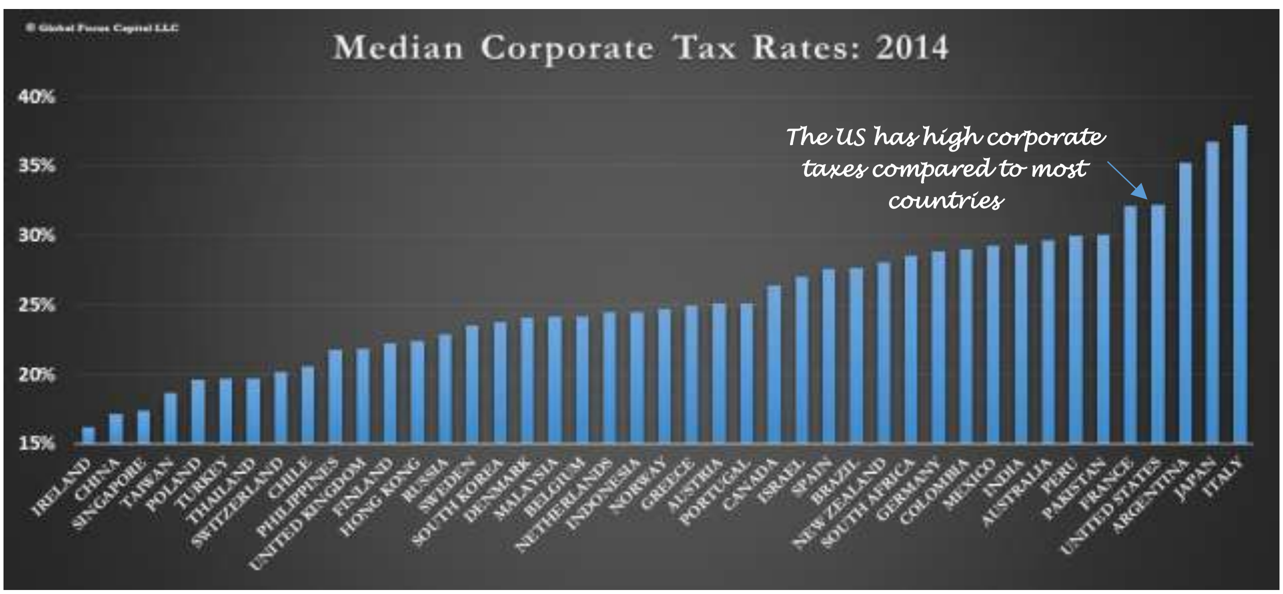
It is very hard to find publicly traded companies that do not conduct a portion of their business away from their native domicile. Company tax rates are at the end of the day an aggregation of tax liabilities incurred under many different forms of taxation and tax jurisdictions.

In our annual review of global company profitability at [Global Focus Capital LLC] one of the approaches that we use is the popular DuPont decomposition of Return on Equity. One of the inputs into this formula is the <u>tax burden</u> of the company. We obtain this information from the financials of companies.

For our sample of roughly 13,000 companies in our equity universe we rely on financial statement data from Factset. While it is impossible to perfectly synchronize income tax information appearing on company financials with actual incurred tax liabilities around the globe we believe that the financial statement data is a reasonable starting point for examining the tax burden of corporations domiciled in different locations.

We use 2014 year-end financial statement information in our analysis of global companies. We initially set out to use 2015 information but found too many companies with sparse information due to different accounting cycle release dates.

Given our sample of roughly 13,000 companies we estimate <u>median effective tax rates by country</u>. A variety of circumstances could affect these numbers including diversity of geographic activities, company profitability levels, accumulated tax credits, etc.



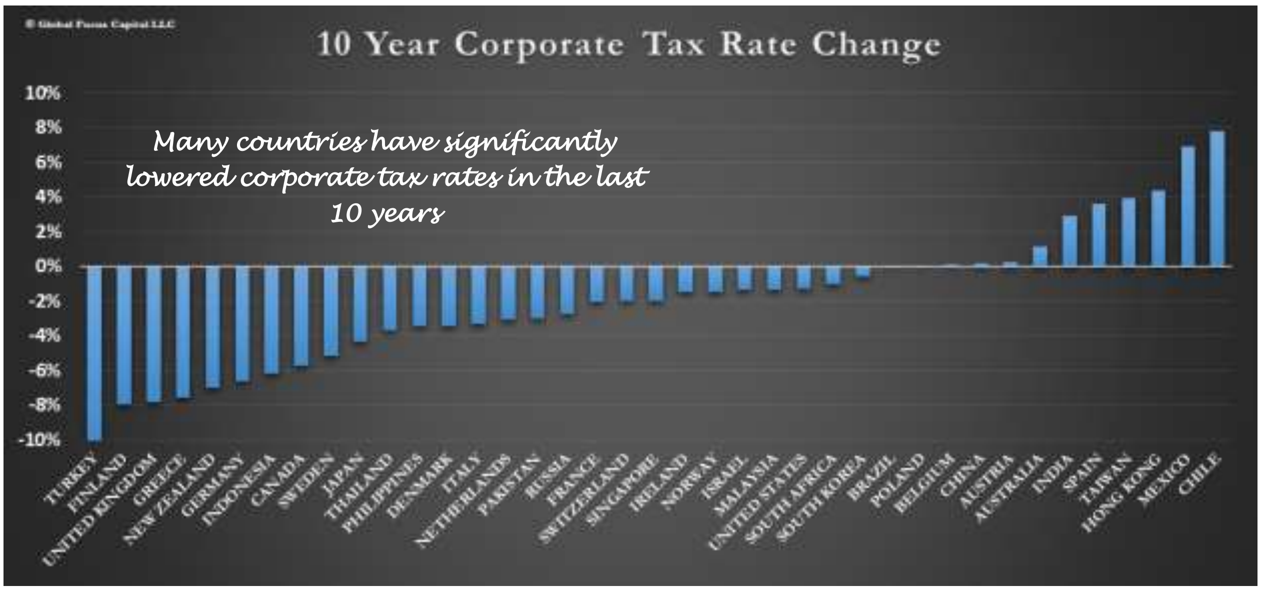
The chart above ranks countries by effective tax rates paid by companies domiciled in those locations. Italy ranks at the top with an effective tax rate of 37%. Japan is next at about 36%. <u>The US ranks fourth in our sample with a median effective tax rate of 32%.</u>

On the other end of the spectrum, companies domiciled in Ireland, China and Singapore exhibit the lowest median tax burdens for 2014. Other large economies with low median corporate tax rates are Switzerland and the UK.

How have effective corporate tax rates changed over the last ten years?

In general the trend has been toward lower tax rates even though in our sample a small subset of countries exhibits slight increases in the median tax burden.

Chile, for example, has had an increase in the corporate tax rate over the last ten years. According to KPMG, Mexico has also seen a slight uptick in corporate tax rates. In other instances increases in median tax rates could be a function of specific company situations.



Where have we seen the biggest drops in effective company tax rates?

Turkey, Finland and the UK stand out but ¾ of the countries in our sample exhibit lower median effective tax rates as compared to a decade ago.

Even for US companies where the stated corporate tax rate has not changed over the last decade (federal rate of 35% plus state & local taxes) the effective tax rate has dropped over 1% since 2004. It is possible that as globalization has increased companies have been able through their foreign subsidiaries to better optimize their tax structure.

Companies in the Health Care and Information Technology sectors have been especially well positioned to take advantage of legal “tax arbitrage” by selectively placing patents and trademarks in low tax locales while still selling into a large number of countries with widely different tax structures.

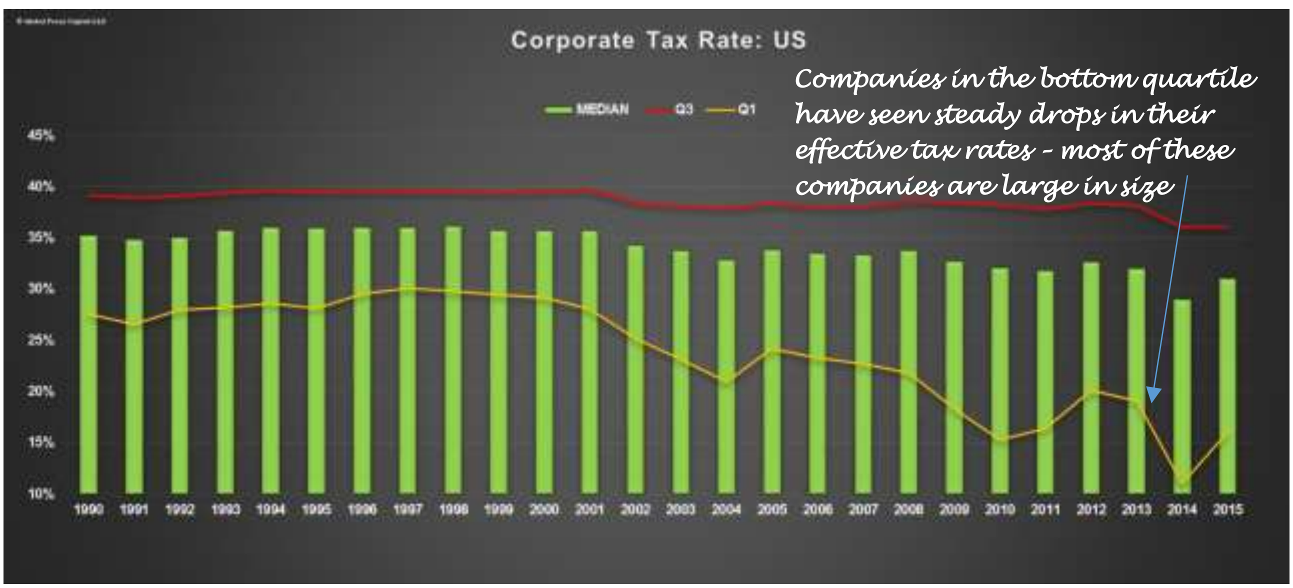
Ireland with an all-in corporate tax rate of 12.5% has remained a favorite location for profit recognition. Several of the recent corporate inversion deals (Medtronic/Covidian, Johnson Controls/Tyco) have post-merger re-incorporated in Ireland. The proposed Pfizer/Allergan merger deal failed largely due to the new US Treasury corporate inversion rules brought about by tremendous political pressure.

How have changes in global tax rates impacted the tax burden of US companies?

As US companies increase their participation in the global economy it stands to reason that greater opportunities for tax optimization would become available. Clearly the larger the company and the wider the geographic footprint the greater the likelihood that a company will legally be able to optimize its tax structure.

By lowering their effective tax bill, shareholders benefit from tax optimization while local tax authorities lose out on potential revenue. Some politicians and economists will also argue that cash held offshore hinders the ability of companies to invest domestically.

Using a slight enhanced sample of US companies going back to 1990 we illustrate how the effective median tax rate has only very slowly trended down over time (green bars).



We also plot how the 3rd and 1st quartile of companies in our sample by effective tax rate have evolved over time.

While the median and the 3rd quartile do not exhibit much change, the 1st quartile (companies with tax rates in the bottom 25% of our sample) has changed significantly especially in the last 15 years.

Companies in the bottom 25th percentile (yellow line) have over time been paying a decreasing rate of corporate tax. While we are not sure why this may be the case we surmise that these companies have more levers to pull. So while the official tax rate has not changed their ability to optimize their tax structure has been enhanced. One reason for this enhanced ability to optimize their tax structure could be globalization.

It stands to reason that the larger the company the more of its activities occur outside of national boundaries. What we find is that for US companies using their 2014 financial data the effective tax rate among the largest 1000 companies is 30.7%. For the next largest 1000 companies the tax rate stands at 32.6%. The next tier down of companies by size has a median tax rate of 34%.

In the United Kingdom we do not see this inverse staggering of effective tax burdens by market capitalization. Dividing the sample of UK companies into thirds we observe very similar tax rates across capitalization tiers. The ability of larger UK companies with greater international activities to conduct tax arbitrage may be compromised by the fact that official UK corporate tax rates are already quite low at 20% according to KPMG. When corporate tax rates are already low there is less of an incentive to recognize profits in offshore tax jurisdictions.

What are the investment implications of lower US corporate taxes?

Lower corporate taxes would most likely make US domiciled companies more valuable as after-tax profitability would be enhanced. By how much? To address this question we resort to using a simple discounted cash flow approach.

The basic idea behind using a discounted cash flow approach relies on using estimates of future cash flows to the company and discounting those cash flows back to the present by using the weighted cost of capital.

Our analysis is based on a discounted cash flow model built for a hypothetical company where the only two parameter inputs that we vary are the applicable corporate tax rate and the level of debt financing. What do we learn from this exercise?

From a pure valuation perspective it is unambiguous that a lower corporate tax rate will result in greater gains for shareholders. Basically, the revenue foregone by tax authorities is now available to shareholders of the company.

But there is an offset in the valuation model via the discount factor of those now higher corporate cash flows. Specifically, assuming the same capital structure, the cost of capital will increase as the tax advantages of debt financing are diminished.

Say corporate taxes go from 35% to 20%. The after-tax cost of debt to the company yielding 5% goes from 3.25% to 4% (the calculation is (1-Tax rate)*Yield). **The net effect of lower corporate taxes is a higher weighted cost of capital** (assuming no changes to the capital structure or risk profile of the business). **A higher cost of capital implies lower a lower valuation assuming unchanged cash flows to equity holders.**

The offsetting impact of a higher cost of capital in discounting cash flows is under most scenarios likely to be of lesser importance to the valuation of the firm compared to the value enhancing effect of higher after tax cash flows**. A cut in corporate tax rates will result under most realistic scenarios in higher firm valuations when using a discounted cash flow methodology.**

If proposals for lower corporate tax rates in the US are enacted we should thus expect the value of US domiciled companies to get a boost.

Every company has their own unique situation so the actual effects are likely to vary quite a bit across companies.

Using a discounted cash flow methodology does, however, allow us to make some general statements about what type of companies are likely to benefit the most should a tax cut take place in the US.

- **A lower corporate tax rate will under most scenarios result in higher firm valuations**

- **The effects of tax cuts are non-linear** as the first few percentage points of tax cuts lead to proportionally higher rates of firm value appreciation
  - Going from a 35 to a 30% tax rate results in a greater increase in firm valuation than going from a 30 to a 25% tax rate

- **Firms using more debt financing will benefit from lower tax rates but less so compared to firms who do not use debt very much**
  - Firms with low debt to equity in their capital structures will increase the most in value
  - This is due to the diminished value of the deductibility of interest expense and the increase in the weighted cost of capital

- **Companies in the <u>Health Care and Technology</u> sectors typically rely less on debt financing and will thus benefit the most from lower corporate taxes**

- **Firms in industries with traditionally high levels of debt financing such as <u>Telecom and Financials</u> will benefit the least from a valuation perspective**

Other implications that arise from a lower corporate tax rate include:

- **Firms with significant tax loss carry-forwards will not be as enticing to merge with** as the value of their tax credits are diminished under lower corporate tax rates

- **The incentive to park money offshore in foreign subsidiaries is diminished but will continue to be present as long as US corporate rates are higher than those in other tax jurisdictions**
  - For example, it is hard to imagine Ireland losing its appeal for profit recognition given its all-in 12.5% corporate tax rate
  - It is highly unlikely that the US corporate tax rate will drop to such a low level in the foreseeable future. For example President Obama has proposed a one-time deal to bring cash held offshore at a 14% tax rate with future cash held abroad eligible for repatriation at a 19% tax rate

- **Repatriating cash held offshore will likely reduce the valuation of companies** as the tax gap between US and low tax locales where most of the money is currently held will still, under all proposals that we have seen, be positive. There is no way around the fact that some companies will be faced with pretty massive tax bills even assuming a generous "tax holiday" program

- **We don't believe that foreign cash repatriation will instantaneously convince US corporations to invest more domestically**

  - If companies wanted to invest more domestically they would have already done so by lowering their already high levels of domestic cash (estimated currently at $1.94 trillion by the Federal Reserve) or by issuing more debt backed up by the balance sheet of the whole company including foreign subsidiary cash holdings
  - Repatriated cash will only be deployed in investment programs if the expected return on such activities is attractive enough to offset the risk. We do not currently see many management teams eager to massively invest in future productive capacity as the global macro environment remains highly uncertain
  - If companies do not find enough attractive investment opportunities the repatriated cash will likely be returned to shareholders via stock buybacks and higher dividends and not directly result in a boost in economic activity

Lowering the US corporate tax rate is a necessity to remain globally competitive but as with any change there will be winners and losers. In the short term corporate tax receipts are likely to drop even after a bump up from offshore cash repatriation (if an attractive "tax holiday" is granted). In the long-term the hope is that the US would become more attractive from an investment standpoint for both US as well as subsidiaries of foreign companies thus boosting economic activity.

Shareholders of US companies will benefit from higher valuations with disproportionate gains accruing to companies using low levels of debt financing. Ironically some of the companies that could see the biggest upward re-valuations also possess the highest balances of offshore cash.

It is highly unlikely that other countries will not institute new lower corporate tax regimes to partially offset lower US rates. In the race to the bottom it is unclear who the real winners and losers will be but in the aggregate global corporate activity will increase its share of the GDP pie.

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