The Tax Cuts and Jobs Act

Corporate tax changes and implications

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- The TCJA changes for business taxes are extremely complex with many of the details and interpretations still unavailable from the IRS.
- This is merely an attempt to provide an overview of what information and analysis is available at this point

Corporate tax prior to the TCJA

- Statutory corporate tax rate was 35%.
- Average US effective tax rate for US corporations over the last 5 years was actually 24.7%.
- For the 14 largest global pharmaceutical corporations, the average effective tax rate was 17%.
- Profits from foreign revenue was not taxed unless the cash was brought back to the US. WSJ estimated that there was $3T in untaxed profits being held outside the US.

How did US corporations lower their tax rates?

- Complex strategies used to transfer Intellectual Property (IP) to foreign corporations.
- One version is called the “Double Irish”
- Note that Ireland intends to phase out this practice by 2020, primarily based on pressure from the EU.

“Double Irish”

- The “Double Irish” is a structure that allows companies to reduce taxable income by setting up two entities—an Irish-registered parent based in a tax haven such as Bermuda that houses a company’s foreign IP rights, and an Irish subsidiary, which licenses the IP and pays royalties in turn.
- Since Ireland doesn’t tax the royalties paid, the company’s tax bill is effectively reduced. There are several countries that do not tax royalties.
- Tax advisers estimate that hundreds of companies have used the Double Irish to move tens of billions of dollars a year to low- or no-tax jurisdictions.
- While Ireland is phasing out this advantage, Malta is being looked at as the next potential location to execute this strategy.

BEPS and Transfer Pricing

- What is Base Erosion?

- Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational companies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.

- The initial project to limit this practice was headed by the OECD was initiated by the G20 in 2012.

- Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise. For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent to the subsidiary is the transfer price.

- Transfer pricing at times is very aggressive and may stray into the realm of being illegal or challenged by tax authorities.

Example - Google

The Google unit in Ireland sells ads across Europe and has paid tens of billions of euros in royalty fees for the use of Google’s intellectual property to a unit in the Netherlands.

Then, pays nearly all those fees to an Irish company that is managed in Bermuda, where there is no corporate income tax.

Example - Apple

- Apple uses a version of the “Double Irish” - Apple Operations International is a legal entity incorporated in Ireland, but managed and controlled from HQ in Cupertino.

- Then, created a subsidiary of the Irish entity, Apple Operations Europe: then, a subsidiary of this entity called Apple Sales International. These 2 subsidiaries were also incorporated in Ireland but operated/ controlled by Cupertino.

- Apple, Inc. designated this network as the official seller of Apple products outside the US. While these products were developed, designed, and programmed in the US and manufactured in China, the right to sell Apple products is transferred on paper to the Irish subsidiaries.

- For the period from 2009-2012, sales were $74B and the taxes due were ZERO.

- A company operating in Ireland is subject to Irish tax only if it is “managed and controlled” in Ireland. Under US law, a company is subject to tax if it is incorporated in the US.

Example - Microsoft

Microsoft assigned the North American rights to their intellectual property in software, operating systems, search engines, and all Web-based products to their Puerto Rican Operations.

Whenever any of these products were sold in the United States, half the profit from the sale was attributed (on paper) to the Puerto Rican subsidiary.

Microsoft had negotiated a deal with the cash-starved Puerto Rican government to pay an income tax rate of 2% on these profits.

Estimates cite a $4.5B in tax savings on goods sold in the US over a 3 year period.

Example - Pfizer

Pfizer’s effective tax rate for 2016 was 13.64%

“Pfizer has astutely managed its tax liabilities over the years, and has structured its business and subsidiaries to minimize its tax exposure in the US by consistently reporting operating losses in the region. The company has effectively turned its US operations into a cost center. One way the company has done so is by developing drugs in the US, manufacturing them overseas, and then buying them back from its subsidiaries at high prices.” Forbes - September 2017

Changes to Business Taxes

- Lowers the corporate tax rate from 35% to 21% permanently

- Establishes a 20% deduction of qualified business income from certain pass-through businesses. However, specific service industries are excluded, unless small companies defined as less than $315k in income on a MFJ return and $157k on an individual return. (Likely not applicable to our investments.)

- Limits the deduction of net interest expense to 30% of earnings before EBITDA for 4 years and 30% of earnings before EBIT thereafter.

- Eliminates NOL carrybacks and limits carryforwards to 80% of taxable income

Changes to Business Taxes (continued)

- Moves to a territorial system with Base Erosion rules

- 100% exemption for dividends from foreign subsidiaries in which the US parent owns at least a 10% stake.

- Eliminates the corporate AMT

- Immediate deduction of 100% of the cost of certain qualified property acquired and placed in service before January 2023, and then a phase down in the next 5 years

- Deemed repatriation of foreign earnings not previously taxed in the US. Earnings will be taxed at 8% and 15.5% for cash / cash-equivalents. The tax due on the overseas profits can be paid in equal installments over the next 8 years.

Interest Deductibility

- There does not appear to be any provision to limit the deductibility of interest expense for domestic members of international groups. Original versions of the House and Senate bills included provisions to limit this deduction.

- A US corporation making deductible interest expense payments to certain related parties may be required to add back such payments in computing its “modified taxable income” for purposes of the Base Erosion minimum tax.

Base Erosion: Payments to Foreign Affiliates

- The TCJA imposes a minimum tax (called the BEAT) on a US corporation's taxable income after adding back certain "base erosion payments."

- Base erosion payments are deductible payments from domestic corporations and branches to foreign affiliates, excluding the cost of goods sold (unless the corp expatriates from the US.)

- The minimum tax in 2018 is 5%, in 2019-2025 at 10%, and 2026 and beyond is 12.6%. There are slightly higher rates for US banks and registered securities dealers.

- The minimum tax applies to corporations with at least $500m in gross receipts.

- The TCJA also disallows deductions for interest and royalty payments to foreign affiliates that are hybrid payments made to hybrid entities. (A multinational company subject to corporate income tax in one national jurisdiction that qualifies for tax transparent treatment in another resulting in significant tax savings. This is accomplished when a company is organized as a partnership in one jurisdiction and as a corporation in another.)

Base Erosion: Global Intangibles Low-taxed Income

The new tax break, for what is foreign-derived intangible income, effectively reduces tax on foreign income from goods and services produced in the U.S. using patents and other intellectual property to 13.125% (and 10.5% on GILTI) until the end of 2025, after which the rate rises to 16.4%.

A deduction is allowed equal to the sum of 37% of foreign derived intangible income (FDII) plus 50% of the GILTI amount included in gross income.

Watch for the acronym GILTI

Previously, royalties paid to a unit in the U.S. would have been taxed similarly to other U.S. income, for which the top corporate tax rate was 35%. The new headline corporate rate is 21%.

The deduction is meant to induce companies with large US operations and significant foreign income from patent royalties to base more of those assets in the US. Such companies, especially in technology and pharmaceutical sectors, often hold foreign rights for their IP (Intellectual Property) in a company based in a low-tax country.

Google

- Reported a $9B adjustment to earnings for 2017 for the deferred tax liabilities on foreign earnings.

- Google's effective tax rate had been 16.8%-21.1% over the last few years.

- Projecting an effective tax rate of 15% as a result of the TCJA.

- Note that 46% of revenue is from US sources.

Apple

- Apple's effective tax rate has averaged 26% over the last 5 years.

- For 2018, Apple estimates 40% of sales revenue will be from the US with their projected effective tax rate under the TCJA to be 15% (as reported in the10K released on 2/2/2018.)

- Apple's overseas cash (foreign profits now subject to US tax) is primarily invested in Google and Microsoft bonds (denominated in US$.) You may remember that Apple issued US corporate bonds and was able to pay the interest on those bonds with the interest earned on the Google and Microsoft bonds purchased with the overseas profits not repatriated.)

Microsoft

- Microsoft's effective tax rate has been 21% over the last 3 years with approximately 50% of revenue coming from US sales.

- Recorded a $13.8B charge for 2017 for the tax impact of the TCJA.

- "As of December 31, 2017, we have not completed our accounting for the tax effects of TCJA. Our net charge is provisional based on reasonable estimates for those tax effects." - Microsoft press release with earnings.

- "The TCJA subjects a U.S. corporation to tax on its GILTI (Global Intangible Low Tax Income.) Due to the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the TCJA and the application of GAAP. Under GAAP, we can make an accounting policy election to either treat taxes due on the GILTI inclusion as a current period expense, or factor such amounts into our measurement of deferred taxes. We elected the deferred method and recorded an estimated $454 million benefit related to GILTI, which is included in the net charge related to the TCJA ." - Microsoft press release with earnings.

Pfizer

- “The TCJA is complex and significantly changes the U.S. corporate income tax system by, among other things, reducing the Federal corporate income tax rate from 35% to 21%, transitioning U.S. international taxation from a worldwide tax system to a territorial tax system and imposing a repatriation tax that is payable over eight years on deemed repatriated accumulated earnings of foreign subsidiaries. Given the significant changes resulting from and complexities associated with the TCJA, the estimated financial impacts for fourth-quarter and full-year 2017 as well as the estimated impact on 2018 Financial Guidance for the effective tax rate on Adjusted income(2) are provisional and subject to further analysis, interpretation and clarification of the TCJA, which could result in changes to these estimates during 2018.” - press release by the company with 2017 earnings.

Amazon

- Amazon’s effective tax rate has averaged 31% over the last 3 years with 66% of revenue coming from the US. No guidance as yet on 2018 tax projections.

- Amazon press release with earnings:

- “The 2017 Tax Act significantly changes how the U.S. taxes corporations. The 2017 Tax Act requires complex computations to be performed that were not previously required in U.S. tax law, significant judgments to be made in interpretation of the provisions of the 2017 Tax Act and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury Department, the IRS, and other standard-setting bodies could interpret or issue guidance on how provisions of the 2017 Tax Act will be applied or otherwise administered that is different from our interpretation. As we complete our analysis of the 2017 Tax Act, collect and prepare necessary data, and interpret any additional guidance, we may make adjustments to provisional amounts that we have recorded that may materially impact our provision for income taxes in the period in which the adjustments are made.”

Summary

- The TCJA will increase business earnings and increase corporate cash
- US Treasury revenue is expected to be significantly less in 2018 (increasing the deficit.)
- After an extended period of significant monetary policy stimulus and strong global growth, do we really need a large fiscal stimulus package now?
- Corporations will pass a large portion of this benefit to shareholders (increase dividends and share buybacks,) increase capital expenditures, increase wages, and likely to engage in more M&A activity.
- The Fed will likely need to accelerate interest rate increases (deemed to be "behind the curve" and if we actually see inflation rise.)
- How does the Fed "unwind" their balance sheet?