MIT Sloan Reunion 2018: Corporate Tax Reform: Why the U.S. Needed it and Will it Work?
AGENDA

- Overview of the Tax Cuts and Jobs Act
  - History of tax reform and tax reform attempts
  - Major provisions in the TCJA
- Why did we need corporate tax reform?
- Corporate tax reform in the TCJA
  - Potential responses to, and effects of, the TCJA
- Looking forward
- Conclusions
Corporate taxation (C corporations)
- Corporate tax rate is set at 21% (previously had a top rate of 35%)
- Full expensing of investment (for five years)
- Limitation on interest expense deductibility
- NOL limitations
- Amortization of R&D after 2021
- Fundamental international tax changes
Pass-through entities

- Deduction for qualified pass-through business income
  - Essentially a 20% deduction
  - But quite complicated with many limitations
- Many of the above provisions listed for corporations
Individual provisions
- Tax rates reduced – e.g., top rate changed from 39.6% to 37%
- State and local tax deduction limited to $10,000
- Personal exemptions eliminated
- Standard deduction doubled to $24,000
- Mortgage interest deduction limited to interest on $750,000 of debt
- Alternative minimum tax will apply to vastly fewer people
- Child tax credit was doubled to $2,000
HISTORY OF TAX REFORM AND TAX REFORM ATTEMPTS
History

HISTORY

- Tax Reform Act of 1993. Corporate rate raised 1% point to 35%. (President Clinton)
- Economic Growth and Tax Relief Reconciliation Act of 2001 (President G. W. Bush)
- Jobs and Growth Tax Relief Reconciliation Act of 2003 (“)
- Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (President Obama)
- American Taxpayer Relief Act of 2012 (President Obama)
2014 Chairman Dave Camp: H.R. 1 (HWM)

- Corporate rate 25%
- Broaden the base (!)
- Territorial, with anti-base erosion measures
Corporate rate 20%
Immediate expensing of investment
Limitation on interest expense
Border adjusted
  - Export revenue not taxable
  - Import costs not deductible
New rate for pass-through business
WHY DID WE NEED TAX REFORM?
PRIOR TO THE TCJA

- U.S. had:
  - A top corporate statutory income tax rate of 35% (higher if one includes subnational income taxes)
  - Worldwide tax system, with deferral
CORPORATE TAX RATES AROUND THE WORLD
(THE TAX FOUNDATION FOR 2017 (SIMPLE AVERAGES))

At 35%, America’s corporate tax rate is the highest in the industrialized world.*

OECD Statistics 2016 bit.ly/HighestRate

REAL TAX REFORM STARTS WITH THE RATE.
U.S. MNC
Subsidiary of the U.S. MNC
ECONOMIC OUTCOMES

- Combination of a high statutory tax rate and a worldwide tax with deferral led to negative economic outcomes
  - Incentives to ‘income shift’
  - Incentives to locate intangibles and operations in other countries
  - Incentives to leave earnings and cash in foreign subsidiaries (e.g., trapped cash)
Credit Suisse March 17, 2015 report, *Parking A-Lot Overseas, At Least $690 Billion in Cash and Over $2 Trillion in Earnings*

Exhibit 4: Earnings Parked Overseas Now Over $2 Trillion, 2001-2014, S&P 500

- **Indefinitely Reinvested Foreign Earnings - Billions**
  - $0
  - $500
  - $1,000
  - $1,500
  - $2,000
  - $2,500


- **Categories:**
  - Others
  - Industrials
  - Energy
  - Information Technology
  - Consumer Staples
  - Health Care

- **Key Points:**
  - Repatriation Tax Holiday
  - CAGR (2005-14) 19%...
  - ...but growth has slowed in recent years

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1: Excludes REITs and companies domiciled outside the U.S.

Source: Calcbench, Company data, Credit Suisse estimates
TOTAL CASH HOLDINGS BY U.S. NON-FINANCIAL COMPANIES

(In billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>'07</td>
<td>$500</td>
</tr>
<tr>
<td>'08</td>
<td>$658</td>
</tr>
<tr>
<td>'09</td>
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<td>'14</td>
<td>$1,684</td>
</tr>
<tr>
<td>'15</td>
<td>$1,684</td>
</tr>
</tbody>
</table>

SOURCE: Moody's
ECONOMIC OUTCOMES

- Combination of a high statutory tax rate and a worldwide tax with deferral led to negative economic outcomes
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  - Incentives to borrow in the U.S.
  - Incentives to acquire companies in other countries (and led to increased acquisitions of U.S. companies by non-U.S. domiciled companies)
  - Incentives to ‘invert’
  - Large variation in effective tax rates
BARRIERS TO MOBILITY: THE LOCKOUT EFFECT OF U.S. TAXATION OF WORLDWIDE CORPORATE PROFITS

John R. Graham, Michelle Hanlon, and Terry Shevlin

Using data from a survey of tax executives, we examine the corporate response to the one-time dividends received deduction in the American Jobs Creation Act of 2004. We describe the firms’ reported sources and uses of the cash repatriated and we also examine non-tax costs companies incurred to avoid the repatriation tax prior to the Act. Finally, we examine whether firms would repatriate cash again if a similar Act were to occur in the future. Overall, the evidence is consistent with a substantial lockout effect resulting from the current U.S. policy of taxing the worldwide profits of U.S. multinationals.

Keywords: repatriation, tax, American Jobs Creation Act
JEI Codes: H20, H25, H26, K34

I. INTRODUCTION

In a frictionless world, capital would flow freely across countries. Within multinational firms, capital would be allocated across divisions, regardless of the location of those divisions, to maximize marginal product and firm value. In reality, tax laws create barriers to capital mobility. Taxes also create incentives for firms to expend resources in an effort to avoid or minimize taxes. In this paper, we investigate whether, how, and to what extent taxation distorts the mobility of capital within firms. In particular, we survey tax executives to examine their firms’ response to the one-time dividend received deduction in the American Jobs Creation Act of 2004 (the Act). The Act granted a temporary dividends received deduction of 85 percent of the extraordinary dividend from foreign earnings repatriated back to the United States, which effectively reduced the rate of tax on the repatriated dividends to 5.25 percent (15 percent - 35 percent statutory tax on dividends).

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Figure 4
Actions Taken to Avoid the Repatriation Tax

Survey responses to the question: Because of the U.S. tax policy to tax foreign earnings, has your company taken any of the following actions to finance U.S. operations in order to avoid repatriating the foreign earnings (in years where the Section 965 election was not available)?

Panel B: Repatriating Companies Only

<table>
<thead>
<tr>
<th>Action</th>
<th>Percentage of Respondents that Answered Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raised capital via debt in the U.S. (N=111)</td>
<td>60%</td>
</tr>
<tr>
<td>Invested in financial assets with lower rate of return than U.S. investments (N=103)</td>
<td>40%</td>
</tr>
<tr>
<td>Other (N=54)</td>
<td>20%</td>
</tr>
<tr>
<td>Considered selling the entire company or some divisions or assets (N=101)</td>
<td>10%</td>
</tr>
<tr>
<td>Decided not to invest in a profitable project in the U.S. (N=102)</td>
<td>5%</td>
</tr>
<tr>
<td>Decreased or did not increase a dividend to shareholders (N=102)</td>
<td>3%</td>
</tr>
</tbody>
</table>
Figure 3
Uses of Cash “Freed Up” by the Cash Repatriated
(N=109)

Survey responses to the question: Recognizing the fungibility of cash, did the availability of the repatriated funds for the purposes indicated above free up other cash for any of the following?

Percent of respondents that answered yes for the factor

- Pay down domestic debt
- Repurchases
- U.S. capital investment
- Hiring and training of U.S. employees
- U.S. R&D
- Acquisition of another firm or assets
- Dividends
- Executive Compensation
- Other
- Capital infusion to foreign subsidiary
- Loan to foreign subsidiary
ECONOMIC OUTCOMES

- Combination of a high statutory tax rate and a worldwide tax with deferral led to negative economic outcomes
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  - Incentives to acquire companies in other countries (and led to increased acquisitions of U.S. companies by non-U.S. domiciled companies)
The effect of repatriation tax costs on U.S. multinational investment

Michelle Hanlon *, Rebecca Lester, Rodrigo Verdi

ABSTRACT

This paper investigates whether the U.S. repatriation tax for U.S. multinational corporations affects foreign investment. Our results show that the locked-out cash due to repatriation tax costs is associated with a higher likelihood of foreign (not domestic) investment. We also find a negative association between tax-excluded foreign cash holdings and the market reaction to foreign deals. This result suggests that the investment activity of firms with high repatriation tax costs is reversed by the market as less valuation-enhancing since that of firms with low tax costs, consistent with foreign investment of firms with high repatriation tax costs possibly reflecting agency-driven behavior.

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1. Introduction

U.S. multinational companies (MNCs) currently hold over $2 trillion in cash, with the majority of this amount held by foreign subsidiaries (Casemate and Lahart, 2011; Davis, 2011). One of the suspected reasons for this offshore cash is the U.S. tax treatment of foreign-sourced earnings. Other tax rules are such that the operating earnings of foreign subsidiaries are generally not subject to U.S. tax until the related cash is repatriated to the U.S. (Ferrell, Hornbook, Timmert, and Pertill 2007) provide evidence that the U.S. tax due upon repatriation i.e., the repatriation tax, which is the U.S. tax less a foreign tax credit for taxes paid to the foreign jurisdiction on the earnings) partially

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0304-405X/2013 Elsevier B.V. All rights reserved.
Test merger and acquisition activity of U.S. multinationals that we estimate to be holding large cash balances due to U.S. taxes.

Our results show that the locked-out cash due to repatriation tax costs is associated with a higher likelihood of foreign (but not domestic) acquisitions.

We also find a negative association between tax-induced foreign cash holdings and the market reaction to foreign deals. This result suggests that the investment activity of firms with high repatriation tax costs is viewed by the market as less value-enhancing than that of firms with low tax costs, consistent with foreign investment of firms with high repatriation tax costs possibly reflecting agency-driven behavior.
Combination of a high statutory tax rate and a worldwide tax with deferral led to negative economic outcomes

- Incentives to ‘income shift’
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- Incentives to leave earnings in other countries (e.g., trapped cash)
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- Incentives to acquire companies in other countries (and led to increased acquisitions of U.S. companies by non-U.S. domiciled companies)
- Incentives to ‘invert’
"In summary, the United States is currently an outlier with a worldwide tax system that taxes the operating income of foreign subsidiaries when repatriated at a 35 percent federal rate (foreign tax credits are allowed). This system leads U.S. companies to 1) leave more cash in foreign subsidiaries, 2) to borrow more in the U.S., 3) be at a competitive disadvantage relative to foreign competitors from territorial jurisdictions, 4) use foreign cash to invest more in foreign locations than U.S. locations, and 5) to engage in merger deals with, or be acquired by, foreign companies who have a tax advantage."
WHAT ABOUT EFFECTIVE RATES?

- Large variation in effective tax rates
Long-Run Corporate Tax Avoidance

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Edward L. Maydew
The University of North Carolina at Chapel Hill

ABSTRACT: We develop and describe a new measure of long-run corporate tax avoidance that is based on the ability to pay a low amount of cash taxes per dollar of pre-tax earnings over long time periods. We label this measure the “long-run cash effective tax rate.” We use the long-run cash effective tax rate to examine (1) the extent to which some firms are able to avoid taxes over periods as long as ten years, and (2) how predictive one-year tax rates are for long-run tax avoidance. In our sample of 2,077 firms, we find there is considerable cross-sectional variation in tax avoidance. For example, approximately one-fourth of our sample firms are able to maintain long-run cash effective tax rates below 20 percent, compared to a sample mean tax rate of approximately 30 percent. We also find that annual cash effective tax rates are not very good predictors of long-run cash effective tax rates and, thus, are not accurate proxies for long-run tax avoidance. While there is some evidence of persistence in annual cash effective tax rates, the persistence is asymmetric. Low annual cash effective tax rates are more persistent than are high annual cash effective tax rates. An initial examination of characteristics of firms successful at keeping their cash effective tax rates low over long periods shows that they are well spread across industries but with some clustering.

Keywords: effective tax rate, tax persistence, cash tax, long-run tax avoidance.

Data Availability: Data used in this study are available from public sources identified in the paper.

We thank two anonymous referees, Dan Dhaliwal (editor), George Piskorski (discussant), Terry Sheehan, and workshop participants at the Columbia University Haas Workshop, the 2005 Annual National Tax Association Meetings, Northwestern University, University of Michigan Public Finance Seminar, Washington University in St. Louis, and the 2005 Brigham Young University Accounting Research Symposium for comments on earlier drafts of this paper. Mr. Dyreng appreciates funding from the Deloitte Doctoral Fellowship. Professor Hanlon appreciates funding from the Ernst & Young Faculty Fellowship at the Ross School of Business at the University of Michigan and the Bank One Corporation Foundation. Professor Maydew appreciates funding from the David E. Hoffman Chair.

Editor’s note: This paper was accepted by Dan Dhaliwal.

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About one of every seven companies had an effective tax rate lower than 10 percent, including Amazon at 6 percent and Verizon at 9 percent. Nine companies paid no taxes at all.

Each circle represents a company, sized by its market capitalization. The largest is Apple, at more than $400 billion, with an effective tax rate of 14 percent.

Combining earnings and taxes for all S&P 500 companies gives an effective tax rate of 29.1 percent. But rates vary widely by industry.

Three big energy firms paid the most taxes in absolute terms: Exxon $143 billion; Chevron $85 billion; and ConocoPhillips $58 billion.

Effective tax rates cannot be computed for several dozen companies because they lost money over the six-year period. For example, A.I.G. lost $63 billion while paying $8 billion in taxes. These companies are still included in overall tax rate calculations.
PROVISIONS AND POTENTIAL CONSEQUENCES OF THE TCJA
The TJCA reduces the corporate statutory rate to a 21% flat rate. Including state taxes, the new rate puts the U.S. in line with the rest of developed nations, with Australia, Belgium, France, Greece, Israel, Luxembourg, Netherlands, Norway, Sweden, and the UK all having planned corporate income tax rate reductions.

Potential effects:
- Relieve pressure to income shift
- Increase incentives to invest in the U.S. (especially for equity financed investment)
The TCJA modifies Section 168 bonus depreciation

- Full expensing of qualified property placed into service after 9/27/17 and before 1/1/23 (percentages phase down after that)
- Interestingly, used property qualifies (as long as new to the taxpayer)
- Should provide incentives to increase investment
  - We will likely see firms accelerate purchases close to the sunset
FUNDAMENTAL CHANGES TO THE U.S. INTERNATIONAL TAX SYSTEM

- Transition tax
- 100% participation exemption
- GILTI (Global Intangible Low-Taxed Income)
- BEAT (Base Erosion and Anti-Abuse Tax)
- FDII (Foreign Derived Intangible Income)
TRANSITION TAX OR MANDATORY DEEMED REPATRIATION TAX

- Earnings amount: accumulated post-1986 deferred E&P measured on 11/2/17 or 12/31/17, whichever is greater
- When: Inclusion in U.S. taxable income in the last year beginning before 1/1/18
- Payment: Can pay in installments over 8 years, backloaded (8% each year through 2022, 15% in 2023, 20% in 2024, 25% in 2025)
- Tax rate: 15.5% on cash and cash equivalents; 8% on the rest (proportional foreign tax credits allowed)
  - What is cash and what is non-cash? Apparently…some interesting questions are arising
  - If earnings are actually reinvested offshore, may need to borrow to pay the tax
INTERNATIONAL TAX

- Participation exemption
  - 100% DRD for foreign-sourced portion of dividends received by a US corporation from 10%-owned foreign corporations (specified foreign corporations)
    - No FTCs allowed

- Does not apply to foreign branch income (branch income has a separate foreign tax credit basket)
**International Tax**

- **Global Intangible Low-Taxed Income (GILTI):** Similar in spirit to Subpart F. The U.S. will tax some portion of foreign earnings currently. Essentially, this will require the inclusion of “high return” “low taxed” foreign income in U.S. taxable income. Some might say a global minimum tax.
  - Rate starts at 10.5% and increases to 13.125% in 2026
  - Separate FTC basket, no carryover of excess credits, and expense allocation applies

Even income that is taxed at > 13.125% in the foreign jurisdiction could be taxed as GILTI because of expense allocation. There is a risk of loss of FTCs with respect to GILTI income.
Base Erosion and Anti-Abuse Tax (BEAT): Similar in spirit to a type of Alternative Minimum Tax. Applies to both outbound and inbound companies.

- BEAT tax liability is the excess of the BEAT rate X modified taxable income over regular tax liability (temporarily adding back R&E and certain business credits)
- Rate starts at 5%, increases to 10% in 2019, then increases to 12.5% in 2026
- Note: Foreign tax credits are not allowed against the BEAT
Foreign Derived Intangible Income (FDII, FIDII, or FODII): FDII is eligible for a 37.5% deduction through 2025 (a 21.875% deduction after that). At a 21% corporate rate, this is a 13.125% rate, then a 16.4% rate.

- Similar in spirit to a “box” of sorts (e.g., a patent box or our old Section 199)
- Provides incentives to export from the U.S. by assessing a lower rate on certain income earned in the U.S. from exporting
- Some questions about compliance with the OECD guidance on innovation boxes and about compliance with WTO
LIMITATIONS ON INTEREST DEDUCTIBILITY

- The TCJA limits business interest deduction to:
  - Business interest income + 30% of taxpayer’s adjusted taxable income
    - Adjusted taxable income is basically EBITDA, but computed on a tax basis
      - Book-tax differences and consolidation rules make it hard to estimate who is affected based on financial statements. (SubF, branch income, and GILTI income are in ATI)
    - Starting in 2022, adjusted taxable income is basically EBIT, computed on a tax basis
  - Applies at a consolidated level for corporations (probably) and at the partnership level for partnerships. Existing debt is not grandfathered
  - Applies to related party and unrelated party debt
  - Exemptions: 1) small businesses (gross receipts < $25M), 2) regulated utilities, 3) certain motor vehicle dealers, and 4) farmers and real estate businesses can elect out
LIMITATIONS ON INTEREST DEDUCTIBILITY

Potential Effects:

- Most investment grade issuers probably will not be affected (not before 2022)
- Companies may locate debt in foreign jurisdiction
  - To avoid U.S. limits (and to preserve foreign tax credits in the GILTI basket)
    - May cause investment to follow to foreign jurisdiction
  - Foreign investment may be less likely to be funded by offshore cash
- Increase in leasing activity (banks own property and lease out)?
- Effect on some M&A (esp. LBOs)?
Many companies are saying it is too soon to tell
- Offsetting and interactive effects of some of the provisions
- Regulations are not written yet
- One thing that is certain…no more trapped cash!
Tax Dollars at Work
Companies have devoted more than twice to buybacks as they have to employees

- Calculated tax savings: $54.5B
- Stock buybacks or increasing dividends: $21.1B
- Business investments (Capital expenditures, R&D, etc.): $12.3B
- Employees (Wages, benefits, bonuses, etc.): $8.1B
- Philanthropy: $1.4B

Source: Bloomberg reporting; Salary.com; California state filings
Note: Figures represent the first year of tax and spending changes
Tax cut scoreboard: Workers $6 billion; Shareholders $171 billion

by Matt Egan  @MattEganCNN

February 16, 2018: 7:42 AM ET
Apple: We'll pay $38B in taxes and add 20,000 jobs in the U.S.
by Jackie Wattles and Seth Fiegerman  @CNNMoney January 17, 2018: 10:28 PM ET

Tax overhaul costs Goldman Sachs $5 billion
by Alanna Petroff  @AlannaPetroff December 29, 2017: 12:50 PM ET

Hostess to pay bonuses in Twinkies as well as cash
February 1, 2018: 5:45 PM ET
RECENT SURVEY BY DELOITTE OF CFOs

Investment Location Expectations

- Higher investment in U.S. operations: 47%
- Higher investment outside the U.S.: 5%
Uses of Repatriated Cash

- Pay down debt
- Hire new employees
- Buy back shares
- Wage increases
- Dividends
- One-time bonuses
MANY OTHER ISSUES

- OECD BEPS Project
- EU State Aid Cases

- How will other countries respond to the TCJA?
CONCLUSIONS

- Lower corporate statutory tax rate and freeing the internal capital market are taxpayer beneficial
- Domestic only companies should benefit
- The repatriation tax is for the most part a “win”
- Net effect of all the rules makes it very hard to predict how firms will respond and what the economic effects will be
- Some multinationals have said the new law gets them half-way back across the ocean, but not all the way to shore