Tax reform readiness - What's next for your business

US Tax Reform: Impact to Corporate Treasury

At a Glance

The 2017 Tax Reform Reconciliation Act (the "Act"), enacted December 22, 2017, includes a broad range of tax reforms with potentially significant business implications from a strategic, operational, and financial perspective. For the CFO and Corporate Treasurer, the reforms could affect everything from capital allocation, funding strategies, and liquidity management practices, to structure and organization, presenting new opportunities and risks to the prior ways of conducting business.

With this in mind, CFOs and Corporate Treasurers should act quickly by evaluating the implications to the company and work across the enterprise to compose short- and long-term strategy and execution plans.

The primary changes resulting from the Act that are relevant to Corporate Treasury include:

- **Lower top corporate tax rates.** The enacted legislation lowers the top corporate tax rate from 35-percent to 21-percent and repeals the corporate Alternative Minimum Tax (AMT).
- **Deemed repatriation.** The Act subjects earnings held outside the United States and previously not subject to US tax to a mandatory repatriation 'toll' tax (at a rate of 15.5-percent on 'cash and cash equivalents' and eight-percent on non-cash assets), payable over eight years.
- **Territorial tax system.** The Act provides a 100-percent dividends received deduction (DRD) for certain qualified foreign-source dividends received by US corporations from foreign subsidiaries. This single layer of tax is backstopped by restrictions around payments that might erode the US tax base (the base erosion anti-abuse tax or 'BEAT') and special rules around highly mobile intangibles income (global intangible low-taxed income or 'GILTI ').
- **New limitations on interest expense.** The legislation restricts the deduction of interest expense in the United States to the sum of business interest income plus 30-percent of 'adjustable taxable income.'

Why this is important to Corporate Treasury

The treasury implications should be analyzed, with focus on six key areas:

1 — Liquidity Mgmt & Forecasting

How much cash will be elected to be physically repatriated? What are cash needs in the US and abroad?

Are working capital needs appropriately forecasted to support repatriation decisions?

2 — Cash Pooling

Is physical or notional pooling optimal? Will current structures subject your organization to extra tax?

3 — Investments

How will evolving cash profiles be invested, both domestically and internationally?

Will changes be required within the investment policy?

4 — Capital Allocation & Corp Finance

How will repatriated cash be allocated? Pay down debt? Return to shareholders? Capital investments?

What is the optimal capital structure, given changes to interest deductions and foreign income treatment?

5 — FX Risk Management

How will changes in global cash flows change your FX exposure profile?

What are the impacts to cash flow forecasting and related hedge effectiveness?

6 — Operating Model

Are your treasury operations located optimally?

Where should IHBs reside?

Which operations should be shifted to the US?

1. *Liquidity Management & Forecasting*

Prior to the Act, in general, foreign earnings were taxed at the 35-percent corporate rate only when repatriated or earned in certain passive income categories, incentivizing US-based companies to hold foreign cash balances earned from their businesses abroad. Many companies funded domestic investment and growth via US-only earnings or debt issued within US capital markets.

As a result of the Act, there is limited tax incentive to leaving the previously earned cash abroad. A 15.5-percent tax will be due on all cash and cash equivalent assets, regardless of whether the cash is repatriated; an eight-percent tax will be applied to all non-cash assets. Corporate Treasury teams should be prepared both to support 'toll' charge calculations and to determine how much cash should be physically transferred back to the United States and for what purpose(s). This will require a detailed cash forecasting model with insight into working capital requirements for each foreign entity, as well as planning for cash uses in the United States.

While cash forecasting accuracy always has been a key treasury KPI, Corporate Treasurers can expect its criticality to be paramount for tax planning activities. Robust cash forecasting will be required to understand where cash will accumulate to support EBITDA modeling, repatriation planning, changing FX exposure management, global cash deployment, and other critical functions impacted by the Act.

2. *Cash Pooling*

With lower US tax cost of foreign cash repatriation, Corporate Treasurers may revisit existing liquidity structures. Many US corporates operate physical pools domestically and support a combination of notional and physical pools throughout the globe, rarely commingling US and non-US cash.

Changes to taxes on foreign earnings and the potential for global restructurings warrant a reassessment of this common approach, uncovering the opportunity to combine global cash pools in certain circumstances. The resulting improved visibility, access, and control on global cash balances could change the way Corporate Treasury departments are structured.

However, the appropriate cash pool structure should be carefully considered. GILTI, BEAT, and other tax changes will impact decisions around the selection of notional versus physical pools, intercompany interest terms, deductibility of interest payments, etc. Corporate Treasurers should work hand-in-hand with their tax colleagues to develop treasury structures that achieve business goals in an effective manner.

3. *Investments*

Investment policies and procedures should be adjusted for potential influx of foreign cash and changing market conditions. As cash repatriation increases US cash balances, Corporate Treasurers may review their investment portfolio strategy for excess cash. Overall market conditions, including interest rate fluctuations, could prompt modifications to portfolio duration, risk tolerance, location, and use of external money managers.

4. *Capital Allocation and Corporate Finance*

Historically, debt-related interest was deductible (with certain limitations). The Act limits the deduction to the sum of business interest income plus 30-percent of 'adjustable taxable income.' This cap on deductibility increases the cost of debt, with rippling impact to capital structure strategy, target leverage ratios, and cost of capital calculations.

Similarly, with the changes to interest deductibility and treatment of foreign income and cash, Corporate Treasurers must closely evaluate the optimal funding sources for both non-US and US expenditures. It may cost less to repatriate foreign cash for domestic expenditures instead of borrowing in US capital markets. Internationally, Corporate Treasurers may elect to borrow in foreign markets and/or keep cash balances lean abroad, as well as alter their approach for funding subsidiaries.

In connection with the 2004 US repatriation tax holiday, the majority of cash repatriated was returned to shareholders through buybacks and dividends[1]. Corporates also may consider paying down debt (which could be the most beneficial if interest expense deductibility cap has been reached), pursuing acquisitions, making capital investments, funding pensions, etc. A dynamic, scenario-based forecast model is key in this decision-making process.

5. *FX Risk Management*

Balance sheet and cash flow hedging approaches need to be flexible, accounting for changes in foreign-currency denominated cash, increases in non-US debt, and other related one-off and ongoing tax planning impacts. Further, related hedge accounting and effectiveness determinations are based on accurate cash forecasts – these assertions may be challenged given the likely volatility of cash flows and balances that will result from impacts discussed earlier.

6. *Operating Model*

In reaction to the changes described above, Corporate Treasurers may need to restructure their overall organization and banking relationships to achieve efficient execution and optimal

economics. Most large, multinational companies have established regional treasury centers and/or in-house banks in the United States, Europe, and/or Asia to closely manage the execution of treasury activities and local banking in each time zone. As capital allocation, repatriation, and investing strategies shift, the use of in-house banking, treasury centers, and other vehicles may evolve. Even operational activities, such as intercompany payment practices, could be affected by cost implications.

What's Next

Corporate Treasury and Tax should coordinate closely to evaluate and strategize around the short- and long-term implications of tax reform:

- Evaluate cash, funding, and investment practices of each legal entity across the company.
- Determine the implications and costs of the Act specific to the company's current liquidity structure and future funding needs.
- Assess key short-term actions to drive benefits, including executing cash movements, as required (note that the IRS issued Notice 2018-07 with guidance on the 'toll' tax and deferred foreign income calculations).
- Design longer-term alterations to global cash management, capital allocation, FX programs, and the operating model, and build an implementation plan in coordination with the broader Finance organization

Although further regulatory guidance is needed to fully analyze the implications of the Act, CFOs and Corporate Treasurers should begin to frame out potential impacts immediately. Allocating sufficient time to implement the necessary changes will be vital to seizing the opportunity tax reform creates to optimize activities globally.

Sources

1. Congressional Research Service, "Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis", May 27, 2011. <https://www.ctj.org/pdf/crs_repatriationholiday.pdf>

Let's talk

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