UBS

Liquidity Perspectives—1Q18

US tax reform: What corporate treasurers need to know

Overview

- US tax reform is here, and the new rules are likely to trigger a strategic shift in how corporate treasurers manage their balance sheets. However, consequences will differ depending on a company's industry, sources of revenue and corporate development strategy.
- Understanding tax reform is critical. In the broadest sense, we think it encompasses three essential components that will immediately affect multinationals with cash offshore: the shift from a global taxation system to a territorial system; the decrease in the statutory corporate tax rate from 35% to 21%; and repatriation of cash held overseas.
- The new tax laws may also affect strategic corporate imperatives relating to debt issuance, capital expenditure, M&A, R&D and shareholder programs. As a result, cash-management strategies should consider adapting to them.
- The global treasury community will also be closely following potential market repercussions stemming from tax reform, including supply dynamics affected by the unwinding of offshore cash investments and a widening government deficit. The offshore to onshore shift may present interesting challenges for the money market fund complex in Europe as it gears up for new reforms.

The tax reform bill signed into law late last year was the most extensive overhaul of the US tax code in more than 30 years, making significant changes to both individual and corporate tax rates. But now that tax reform is here, corporate treasurers are sifting through the law to determine its effect.

In this year's inaugural piece, we examine how these reforms may trigger a strategic shift in how treasurers manage their balance sheets, with differing consequences depending on a company's industry, sources of revenue and corporate development strategy. From capital expenditure to research and development (R&D) and from debt issuance to mergers and acquisitions (M&A), tax reforms will likely challenge the status quo and push treasurers to significantly reconsider their cash-management strategies.

Understanding tax reforms

In the broadest sense, corporate tax reforms encompass three main components.

The first component constitutes a paradigm shift, with a move from a global taxation system to a territorial system, where companies will be subject to US taxes only on profits they generate domestically (in the United States). The second important component lowers the statutory corporate tax rate from 35% to 21%. Combined, these factors should favor companies that derive the majority of their profits in the United States, whether these companies are US owned or subsidiaries of foreign multinationals. Such industries include those operating in the retail, telecommunications and health insurance sectors, just to name a few.

A third component, however, will provide an important boost to companies that currently have untaxed profits held offshore. Prior to tax reform, foreign subsidiaries of US headquartered companies did not pay US taxes on earnings from abroad until that money was returned home (repatriated), at which point they were subject to the same tax rate as their domestic counterparts. At 35%, the US corporate tax rate was among the highest in the world, which led many multinationals to keep their overseas earnings (not just inclusive of cash) held in offshore entities. As a result, total overseas earnings for all US multinationals swelled and were recently estimated at $2.6 trillion.[1] However, a provision in the new tax code will allow companies with cash trapped overseas to pay a one-time

[1] Offshore Shell Games, Institute on Taxation and Economic Policy, October 2017.

mandatory tax of 8% for illiquid assets (such as factories and equipment) and 15.5% for cash and cash equivalents when repatriating the cash. Corporations can opt to pay the tax in installments over an eight-year period. According to the Wall Street Journal, the US government estimates it will collect $339 billion from the tax over the next 10 years.[2]

The corporate treasurers' role
A well-designed cash management strategy supports a company's objectives and should be flexible to meet key strategic imperatives. The following table examines how these imperatives may be impacted by tax reforms, and how cash management strategies could adapt.

Tax reform: Potential consequences and considerations

Strategic imperative	Key reforms	Cash management considerations
Shareholder programs	Repatriation could result in an increase in shareholder programs, such as dividend payments and share buybacks.	Cash balances may move from strategic buckets into reserve and operating buckets to meet shareholder programs. A shift from offshore to onshore entities could also take place. Offshore money market funds can be tapped as a sweep vehicle while unwinding longer-term strategies. Onshore money market and ultra-short cash management strategies can be used for easy access in order to meet quarterly shareholder programs.
Capital expenditure & M&A	Full and immediate depreciation on purchases of tangible assets, such as factory equipment and machinery between 2017 and 2022, could increase capital expenditure. The accelerated depreciation provision could also spur M&A activity if the acquisition target involves tangible assets.	No effect to income statement as purchases are already immediately expensed. However, 100% immediate depreciation means higher cash balances as a result of a lower tax bill. Companies may have to increase their reserve cash buckets to maximize risk-adjusted returns, while still having easy access to take advantage of M&A opportunities.
Debt issuance	Repatriation will likely reduce the need to issue debt for certain firms given their improved ability to tap their global cash pools. However, the provision regarding limited deductibility of interest paid on borrowing (no more than 30% of EBITDA) may make debt less attractive for certain companies.	Given that interest income can be added to EBITDA when calculating the limit on interest deductibility, maximizing returns on excess cash balances could help mitigate the effect of the interest deductibility provision. A well-designed cash segmentation strategy could be helpful in achieving this goal.
Research & development	The elimination of the Alternative Minimum Tax (AMT), which had previously limited the number of deductions and credits companies are allowed to make, should benefit R&D credits.	The elimination of the AMT may have a similar effect on R&D as the accelerated depreciation on capital expenditures. Cash on-hand may need to be deployed in easy-to-liquidate vehicles to meet increased R&D requirements.

[2] How the Tax Law Will Affect U.S. Firms Bringing Overseas Money Home, The Wall Street Journal, January 16, 2018.

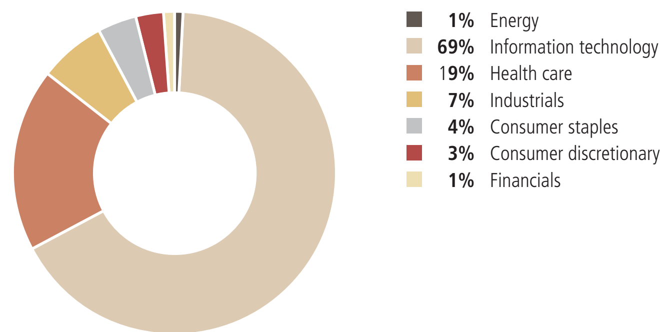
Market impact
One broader concern to the global treasury community is the market repercussions that tax reforms may have in 2018. Most cash balances that are subject to repatriation are primarily USD-denominated and held in US Treasuries and corporate bonds. Shifting these assets onshore to fund shareholder programs could increase the supply of available securities in a year when the US Treasury is expected to significantly raise bill issuance to meet rising deficits.

Both of these factors may put an upward pressure on yields, further accelerating the process of raising interest rates already put in motion by the Federal Reserve. However, given that not all corporations will repatriate at once, nor will they all immediately shift into shorter-dated vehicles, we believe that repatriation is unlikely to cause a supply shock. In any case, the pace of shifting from onshore to offshore should be monitored as the year unfolds.

Another interesting dynamic to monitor closely in 2018 concerns the offshore money market fund complex, as US tax reforms may present both opportunities and challenges for these important cash-management vehicles. Companies may consider a higher allocation to offshore money market funds as they slowly unwind longer-dated strategies while maintaining significant balances overseas. Rising short-term rates may further bolster the case for holding balances in these shorter-dated vehicles. However, the challenge remains that some assets, albeit small, may shift to the US, which poses another interesting dynamic to monitor closely, especially in a year in which European funds are preparing to implement new reforms.

Conclusion
US tax reform presents corporate treasurers with cash-management challenges and opportunities. While clearly US multinational corporations will be the most immediately affected by the reforms, global treasury community will surely feel some of the repercussions. Cash managers worldwide will find it more important than ever to monitor developing dynamics and prepare for their outcomes.

Sector breakdown of S&P 500 untaxed overseas cash



Source: Goldman Sachs Global Investment Research using 2016 10-Ks.

For marketing and information purposes by UBS. For professional clients, institutional investors and US retail clients only.

The views and opinions expressed were current as of February 2018 and may change without notice. We encourage you to consult your Financial Advisor regarding your personal investment program.

UBS Asset Management (US) Inc. serves as distributor for 29 US SEC-registered money market funds and is located at 1285 Avenue of the Americas, New York, NY 10019.

You could lose money by investing in a money market fund. Although a money market fund seeks to preserve the value of your investment at $1.00 per share, a fund cannot guarantee it will do so. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. A money market fund's sponsor has no legal obligation to provide financial support to a money market fund, and you should not expect that the fund's sponsor will provide financial support to a money market fund at any time. For more information on money market funds, contact your Financial Advisor or call UBS Asset Management (US) Inc. at 888-793 8637. He or she can send you a current prospectus, which includes a discussion of investment risks, sales charges, expenses and other matters of interest. Please read it carefully before you invest.

UBS Asset Management (Americas) Inc. and its affiliates do not provide tax, legal or accounting advice. This material has been prepared for informational purposes only, and is not intended to provide, nor be relied upon for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.

© UBS 2018. All rights reserved.
18-0159 C-0617 2/18
www.ubs.com/am-us

UBS Asset Management (Americas) Inc. is an indirect asset management subsidiary of UBS Group AG.