Strategy

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The Trump Tax Plan and Its Implications for Cash Portfolios

Contacts

Lance Pan, CFA®
Director of Investment Research and Strategy
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

Abstract

The Republican bill represents a starting point for tax and budget negotiations. While details are lacking, the current plan offers some interesting angles for market participants to think about their liquidity investment strategies. We highlighted parts of the bill relevant to corporate cash investors and their potential impact on issuers and investors in the short-term debt market. We advise our readers to be patient, stay liquid and think strategically during this waiting period.

Introduction

After weeks of negotiations behind closed doors, Republican leaders unveiled a nine-page document on reforming the tax code on September 27, 2017. Politicians and market pundits quickly jumped into action, looking at every angle to determine potential winners and losers from the proposal. The long-on-promises and short-on-details nature of the so-called "Trump tax plan" left out many details, rendering many of the projections little more than conjectures and educated guesses.

Since the tax framework touches many important subjects that impact the corporate treasury management community, we want to keep the dialog going by addressing the plan's potential impact on market liquidity and treasury investment strategies. Although the plan represents an early blueprint of the finished legislation, understanding the key issues at stake may assist our readers with their internal discussions and perhaps advanced planning.

For the purpose of this commentary, we focus on the aspects of the tax plan we deem to have direct impact on treasury portfolio strategies.

Summary of the Tax Plan

Below is a high level summary of the "unified framework for fixing our broken tax code" released on September 27, 2017.

1) Personal Taxes

- The seven tax brackets are consolidated into three (12%, 25% and 35%). Income levels associated with each bracket are unknown. It leaves the possibility open for an additional top tax rate for high earners.
- The framework roughly doubles the standard deduction while removing allowance for personal exemptions.
- It eliminates most itemized deductions, but retains deductions for home mortgage interest and charitable contributions. Tax benefits to encourage work, higher education and retirement security will also remain.

- It calls for increased child tax credit and higher income levels at which the credit begins to phase out.
- It repeals the alternative minimum tax (AMT) and the estate tax.
- It envisions the use of a "more accurate measure of inflation" to index the tax brackets and other tax parameters.

2) Corporate Taxes

- It reduces the corporate tax rate from 35% to 25% and eliminates corporate AMT. It limits the maximum tax rate for pass-through entities to 25%.
- It allows businesses to immediately write off the cost of capital investments for at last five years.
- It partially limits the deduction for net interest expenses by corporations. It repeals or restricts most. exclusions and deductions. It explicitly preserves tax incentives towards research and development (R&D) and low-income housing.
- It will subject foreign profits of US corporations to a lower tax rate on a global basis than domestic earnings.
- Accumulated offshore profits will be considered already repatriated. No specific repatriation tax rates were supplied, but illiquid assets will be subject to a lower tax rate than cash or cash equivalents. Payment of the liability will be spread over several years.

Items of Interest to Institutional Cash Accounts

The lack of details makes it difficult to gauge with accuracy how the new law will impact the corporate cash investor. With this caveat, we provide a few items of relevance.

A) Lower corporate tax rate to 20%

A lower corporate tax rate would immediately boost profitability and business activities, leading to more hiring and capital spending, higher dividends and share buybacks, higher equity valuation and the wealth effect. The list of potential positive effects of corporate tax cuts is understandably long. The biggest beneficiaries would be firms with higher effective tax rates, including banks.

Banks will benefit from lower corporate tax rates in two ways – from direct tax savings and from robust client activities such as higher business loan demand and higher investment banking activities. As an example, executives of Citigroup and Morgan Stanley estimated that the reduction of the corporate tax rate to 25% (the Trump plan calls for 20%) would lift the banks' earnings by 5% and 15%, respectively[1].

Issuers with high effective tax rates tend to access the short-duration debt market more frequently due to the tax benefits. We think that, over the long-term, investors will benefit from better credit ratings of corporate borrowers in a low tax rate regime when economic growth picks up and firms' fundamental credit strength improves. Borrowers with tarnished credit profiles that languished in a sluggish economy may become creditworthy enough to return to the short-duration debt market.

[1] Telis Demos, Liz Hoffman, Justin Baer and Rachel Loise Ensign, What awaits Wall Street in Trump tax plan, the Wall Street Journal, Markets section. September 29, 2017. https://www.wsj.com/articles/what-awaits-wall-street-in-trump-tax-plan-1506596402

B) Full depreciation of capital spending

The immediate full expensing of capital investments for five years encourages companies to make more capital purchases more quickly. Understandably, this provision will benefit firms in industries that are more capital intensive and with high effective tax rates, including manufacturing, materials and resources and telecommunications. Increased capital spending is no doubt stimulative to the economy, and one would expect higher debt issuances from these industries to fund capital expenditures.

C) Reduced deductibility of corporate net interest expenses

Offsetting the immediate tax write-offs of capital expenditures, the elimination or reduction of tax deductions of net interest expenses may hurt companies relying on borrowed funds for growth. The current tax system of giving preferential treatment to interest over dividend receives frequent criticism for encouraging firms to take on more risk by funding themselves with debt instead of equity shares. The new proposal would likely increase funding costs for firms with below invest grade credit ratings, issuers of high yield bonds, and mergers and acquisitions deals funded with leveraged loans.

Banks as a special class of borrowers may be exempt from this provision. The tax plan said negotiators “will consider the appropriate treatment of interest paid by non-corporate taxpayers.” Banks could argue that in the course of conducting normal banking businesses, their interest expenses are akin to costs of goods sold for non-financial firms.

D) Repatriation of offshore cash at a reduced tax rate

Institutional cash investors are keenly interested in the movement of the stockpiles of cash and liquid investments stashed offshore by foreign subsidiaries of US companies. The tax plan proposes a territorial system to tax US corporations only on domestic earnings. It offers partial exemption on foreign earnings and full exemption on dividends from foreign subsidiaries. Accumulated untaxed earnings offshore will be treated as already repatriated and subject at an unspecified, presumably low, tax rate. The repatriation tax will be spread over several years.

The tax plan did not specify the repatriation rate, the scope, or the timeframe it will be applied, but it is apparent that the “repatriation tax” will be mandatory on all accumulated earnings and that it will be lower than the 20% domestic rate. An earlier Republican tax plan suggested 10% for cash repatriation.

Companies that hold significant cash positions offshore, including pharmaceutical and technology companies, likely already have strategies in anticipation of these changes. Such strategies may include keeping their offshore portfolios liquid to bring it onshore for capital expenditures, equity and bond buybacks, mergers and acquisitions and other planned activities.

E) Minimum foreign income tax on a global basis

An item on the tax plan that did not receive much attention is a proposed new tax “to prevent companies from shifting profits to tax havens by imposing a minimum tax on foreign earnings on a global basis.” Under this tax regime, a multinational corporation that paid more than the minimum rate in foreign taxes will not owe any US taxes. If a firm’s overseas tax was below the minimum, it would pay the difference to the US. This provision was included to deter corporations from using tax havens such as Bermuda or the Cayman Islands that have no or very low corporate taxes to shelter their foreign earnings.

An interesting peculiarity is that the tax plan says the new tax would apply on a global basis, providing some relief for firms operating in both high and low tax jurisdictions. Let’s consider an example of a minimum foreign tax rate of 15% and a corporation receiving half of its foreign earnings from a 25% tax-rate country and the rest from a country without income tax. The firm would have to pay 15% to the US on income from the second country. The resulting effective rate would be 20% [(25%+0%+15%)/2]. If the tax is applied globally, the same corporation would only have to pay 2.5% to the US, resulting in a 15% effective rate [15% - (25%+0%)/2].

Together with repatriation of offshore cash, the implication of this tax provision is that the market for offshore investments will be reduced meaningfully as cash moves back onshore and loopholes are closed. Providers of offshore investments, such as non-US money market funds and banks borrowing Eurodollar deposits, should be prepared for this wave of asset migration.

Possible Bond Market Implications

In addition to firms and sectors that may be directly impacted by the tax reform, one also needs to be aware of possible market implications from the implementations of such changes. The following is a sampling of what may occur, although a lot depends on the details in the final version.

A) Lower demand for US Treasury securities

A large portion of offshore retained earnings has been invested in high-quality, liquid assets such as US Treasuries. It is partially reflected in the fact that Ireland, with the lowest corporate tax rate among industrialized nations, has been the largest net purchaser of Treasuries by country for the past six years. As an example, Microsoft Corporation's latest 10-K filing shows that $129 billion of its 133 billion cash and short-term investments was held by foreign subsidiaries, 87% of which was in turn invested in US government and agency securities. Mandatory repatriation of offshore cash could meaningfully reduce demand for Treasuries and lead to higher bond yield, all else being equal. Over time, the expectation of higher debt burden from deficits created by the tax plan, estimated to be in excess of $2 trillion over a 10-year period, will also pressure Treasury yield higher and lead to price concessions.

B) Changing corporate issuance dynamics

Borrowing by corporate issuers may change in a number of ways. As noted earlier, issuers in cash rich industries should have more discretion over repatriated cash and have lower issuance needs. The loss of interest deductions may encourage firms to use more equity financing and less debt financing, further reducing corporate supply. The end to interest deductions and the move to a territorial tax system may also encourage US companies to issue bonds in foreign markets to benefit from tax savings there. These maneuvers would again reduce corporate issuance in the US. Lastly, the retreat of firms with abundant offshore cash (and high credit quality) from the US corporate bond market will leave it overrepresented by issuers with few alternatives to debt financing. The trend could lower the average credit worthiness of issuers in the domestic market.

C) Beating the clock trades

Bond issuers and financial markets are well known for anticipating policy changes and modifying their behaviors before such changes take effect. For example, immediate expensing of capital expenditure over five years may cause firms to change the timing of capital spending either by delaying immediate purchases or accelerating future purchases. The elimination of interest deductions may result in a wave of near-term debt issuances to capture interest deductions ahead of the effective date, thereby locking in tax savings. Likewise, companies with high effective tax rates may want to repurchase their own bonds at high premiums before changes take effect to reap tax benefits. In short, these waves of bond issuances designed to beat the clock may cause the market to spike up in issuance volumes before reaching a new level of equilibrium over time.

What Fate Unknown

After a few days of initial optimism, financial markets came to the realization that tax reform as complex as the one proposed needs to overcome many difficult challenges before becoming law. Political deal-making and time constraints will affect the outcome and timing of the proposal becoming law.

A) Content uncertainty

Hours after the tax plan was unveiled, displeasure was heard from Congressional Republicans in states with high state and local taxes. As no Democrat was expected to get on board with the proposal, Republican leaders need almost all of the 52 GOP senators to secure a simple majority. Recent party leader comments suggest the final version may relax prohibitions on local tax deduction and other exclusions. Disagreements and negotiations among the GOP ranks appear to suggest that the final agreed-upon legislation will look more like tax cuts than tax reform. The resulting fiscal deficits could be larger than projected.

B) Budget reconciliation uncertainty

With the high probability of the bill not surviving a Democratic filibuster in the Senate and its failure to achieve revenue neutrality over the next decade, Republicans will need to pass the legislation through budget reconciliation by attaching it to the fiscal year 2018 budget bill. Both chambers of Congress need to pass their own versions of the budget bill, work out their differences in a single unified bill, pass it again and submit it to the President for approval to turn it into law. This means that, in addition to agreeing on the details of the tax plan, major factions within the Republican Party will need to agree on the budget as well. As of this writing, the three versions of the budget from the White House, Senate and House Republicans are still a long way from being joined as a single budget. The reconciliation process means the tax bill faces the risk of not having enough yes votes to advance to the next stage.

C) Timing uncertainty

The administration had an ambitious goal of signing the bill into law by the end of October 2017, but that looks increasingly unlikely. Treasury Secretary Steven Mnuchin admitted recently that the August 2017 deadline he made during his confirmation phase "was wrong." On the new bill, he and House speaker Paul Ryan moved back the goal post from late October to November and again to December of this year[2]. Republicans have the urgency of completing the bill by the end of this year before running risk of being derailed by the mid-term elections in 2018. Still, the December deadline looks challenging given the limited number of legislative days left and a long to-do list in Congress including confirming a new Federal Reserve Chairman. Market observers estimated that the more likely date of the bill's passage will be in late first quarter to early second of 2018.

Conclusion – Be Patient, Stay Liquid, and Think Strategically

The Republican tax bill represents a starting point to demonstrate progress by the White House after failed attempts to roll back Obamacare. It also provides a framework for Congress to work on budget resolution, with which the tax bill will be bundled. The finished version may look substantially different and may be several months from becoming reality, but the current plan offers some interesting angles on liquidity investment strategies for short-term debt market participants to contemplate.

We discussed a few items of interest that cover borrowers, users and investors of cash and liquidity products. We analyzed several likely and logical behaviors by market participants. While the content and timing of a new law remains uncertain, it is prudent to monitor the legislative process and consider alternative plans to safeguard

[2] Alexis Leondis, Mnuchin says he was "wrong" about a tax overhaul by August, Bloomberg, August 25, 2017. https://www.bloomberg.com/news/articles/2017-08-25/mnuchin-says-continuing-to-revisit-2017-target-for-tax-overhaul

one's liquid portfolio from market volatility and unplanned liquidity needs. As we await the appointment of a new Fed chair, hope for a peaceful resolution to conflicts on the Korean Peninsula and monitor the impact of separatist movements in the European Union, we are reminded again that the Republican tax reform is but one of several key events that will shape our investment landscape in the near to medium term.

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Capital Advisors Group, Inc.
29 Crafts Street, Suite 270, Newton, MA 02458
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com