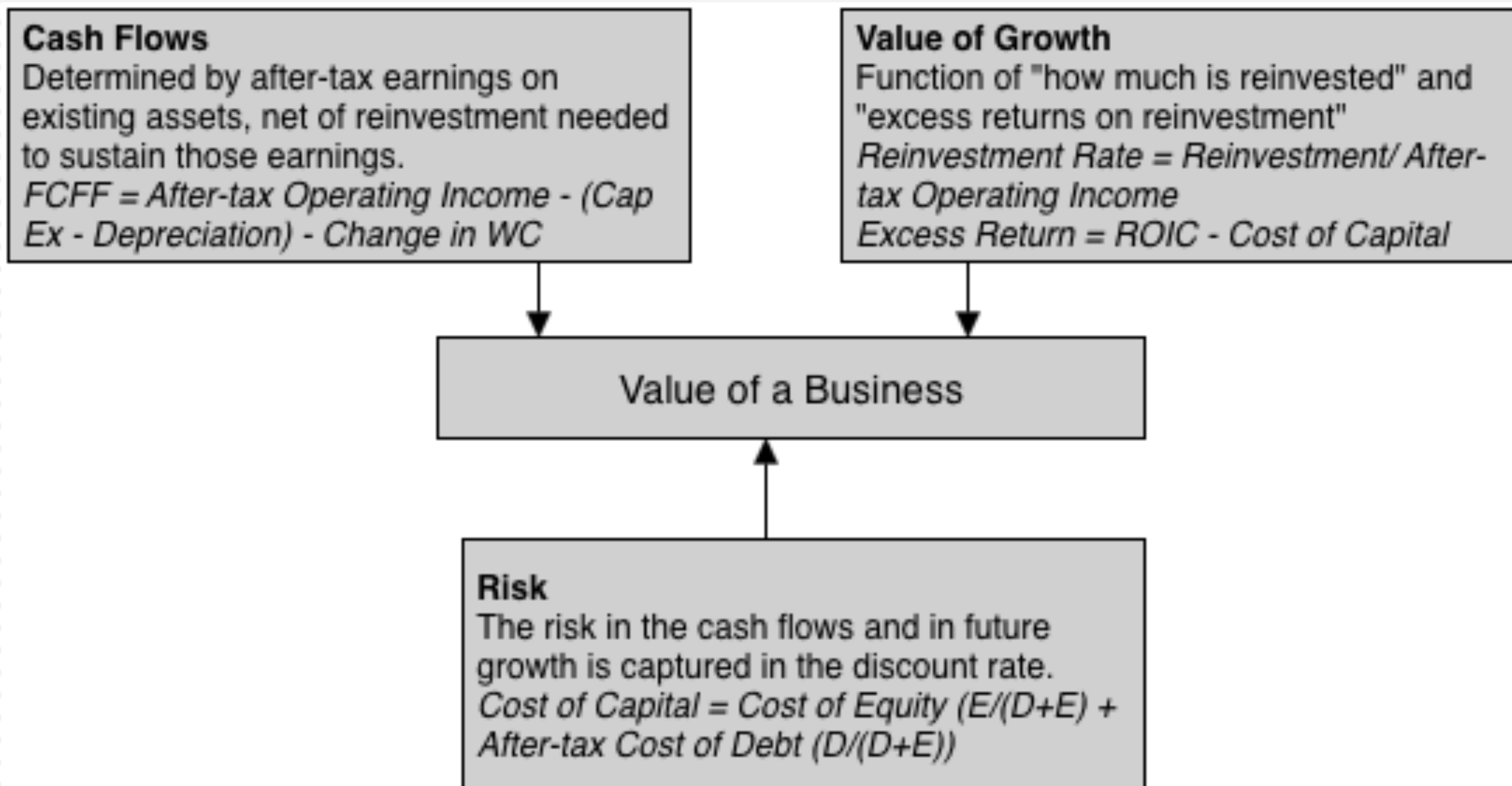
TAX REFORM: PROMISE OF PLENTY OR POISONED CHALICE?

Aswath Damodaran

The Tax Reform Wagon is back..

- Every two or three decades, the US political establishment wakes up to a truth, i.e., that the US tax code is an abomination, which encourages perverse behaviors.
- Every tax reform package starts off by aspiring to make changes that will make the code simpler and fairer.
- Unfortunately, the end result is usually a more complex, less fair code.
- In 2017, as the tax reform train rolls in, the question becomes: Is this time different?

Value: The Big Picture



Taxes, Cash Flows and Growth

The Tax Code provisions on tax rates, tax credits & expensing

- **Statutory US tax rate** – Tax rate on US income
- **Foreign income taxation** – Tax treatment of foreign income
- **Tax Credits/Deferrals** – Special tax provisions
- **Capital Expensing** – Tax treatment of capital investments

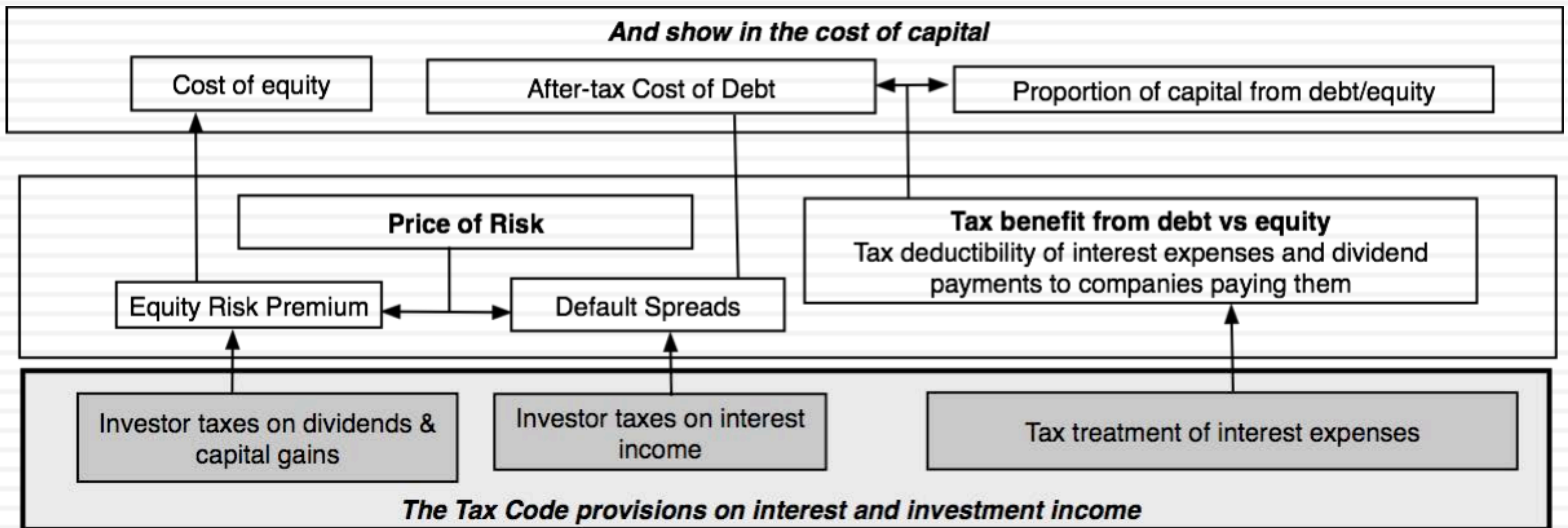
Affect corporate tax payments & investment behavior

- **How much is paid in taxes** – Measured with an effective tax rate
- **How much is domestic/foreign income** – Reported income from US and foreign sources
- **How, where and how much is invested** – Captured by how and where capital is invested

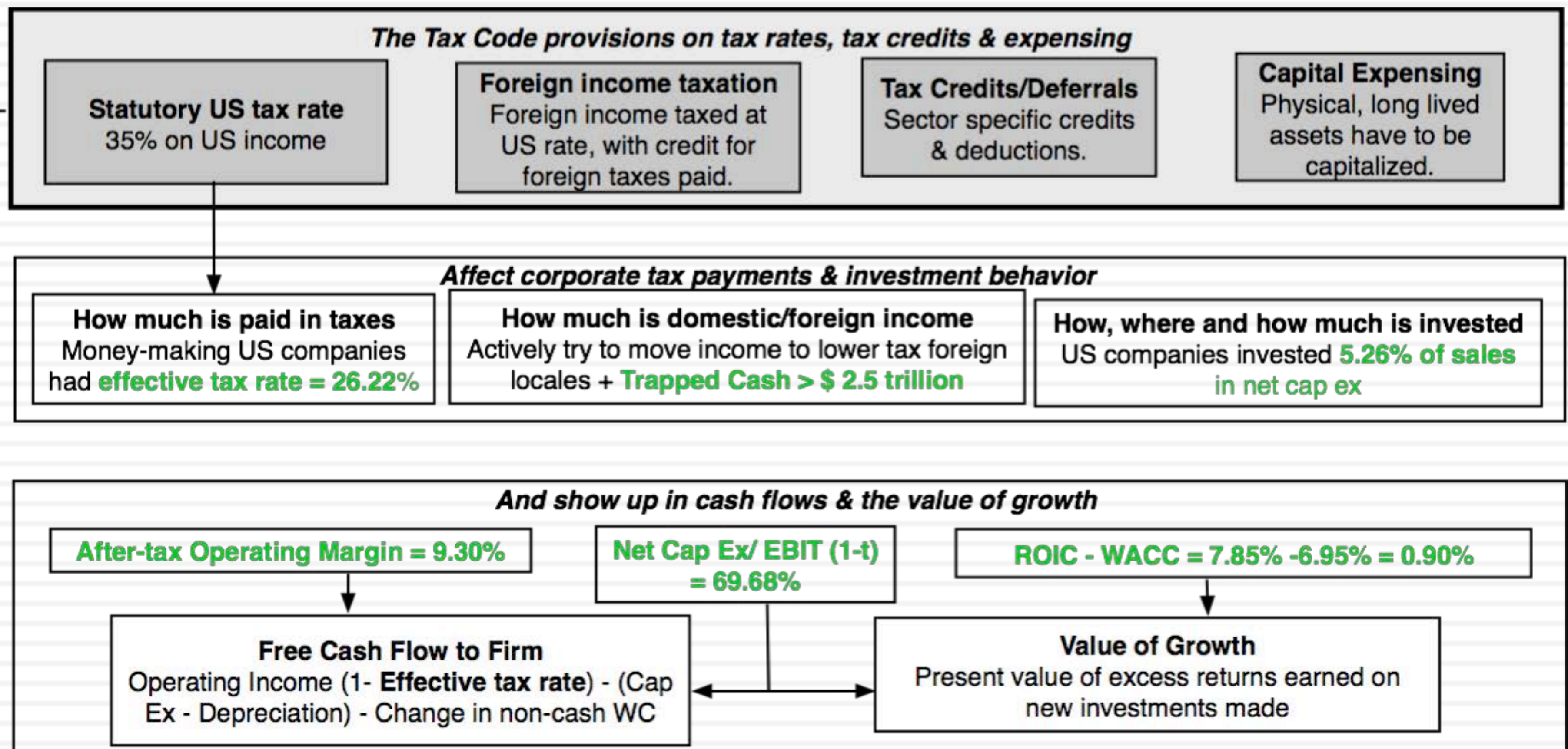
And show up in cash flows & the value of growth

- After-tax Operating Income → **Free Cash Flow to Firm**: Operating Income (1- **Effective tax rate**) - (Cap Ex - Depreciation) - Change in non-cash WC
- Reinvestment → Free Cash Flow to Firm; Value of Growth
- Excess Return = ROIC - Cost of Capital → **Value of Growth**: Present value of excess returns earned on new investments made

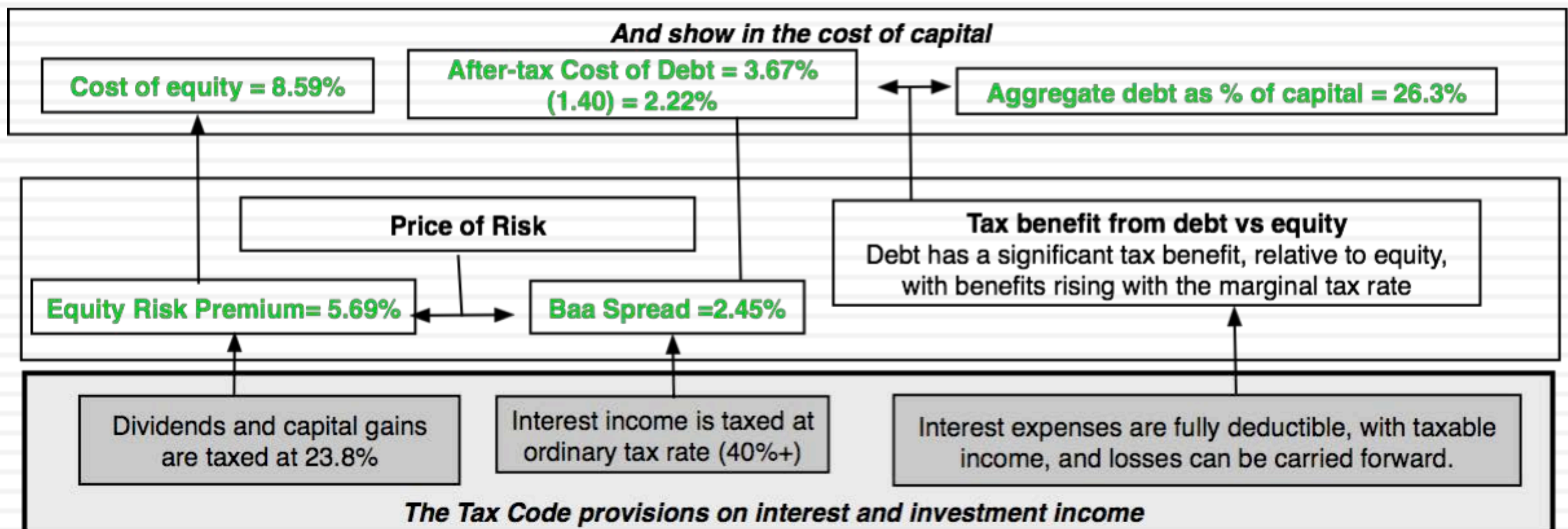
Taxes and Discount Rates



The Current Tax Code: Cash Flows and Growth Effects



The Current Tax Code: Discount Rate Effects



The Proposed Changes: New Tax Code?

- Statutory Tax Rate: The statutory tax rate for corporate income generated in the United States will become 20%.
- Foreign Income: The US will shift to a territorial tax model, resulting in foreign income being taxed at the foreign tax rate, with no additional assessments for US taxes. There will be a one-time tax that will be assessed on trapped foreign income and after the tax is paid, the cash will be effectively untrapped.
- Expensing & Capitalizing: Rather than amortize/depreciate capital expenses, which spreads the tax benefits over time, companies will get the tax deduction up front, which increases value (for a limited period)
- Interest Expense Deduction: There will be limits put on how much interest expense will be deducted for tax purposes, and only for some types of corporations.

The Expected Effects

	After-tax Cash Flows	*Cost of Capital*	*Value of Growth*
1. Lower Statutory tax rate on US income	Lower effective tax rate, leading to higher after-tax cash flows and returns on capital. Bigger effect on firms that derive most or all of their income in US.	Lower tax benefits from debt, raising after-tax cost of debt & capital, and more so for firms with a lot of debt.	Depends on how much return on capital changes, relative to cost of capital. Firms with little debt & high effective tax rates will see biggest benefit and firms with high debt & low effective tax rates will be hurt.
2. Taxes on Foreign income	Lower effective tax rate & higher after-tax cash flows. Bigger effect on firms that derived & repatriated substantial foreign income.	May induce more borrowing outside US in higher tax countries.	One-time release of trapped cash could increase reinvestment, but value will depend upon whether investments generate excess returns.
3. Expensing & Capitalizing	Reduce cost of investing, by moving tax benefits up front rather than spread over time.	None.	Will increase value of growth at firms with substantial physical assets. Low or no effect at companies with intangible assets.
4. Interest Tax Deduction Limits	None.	Will increase cost of capital at companies that test the limits. (Too much debt or debt in the wrong places)	Will decrease value of growth and more so at firms that violate interest deduction limits.

The Winners

1. Pay high effective tax rates, either because they derive most or all of their income in the US or because they repatriate foreign income
2. Have low or no debt in their capital structure, thus immunizing themselves from the loss of tax benefits of debt.
3. Earn healthy returns on capital, which will allow them to reinvest their higher earnings back to generate value.
4. Have more physical assets than intangible assets, enabling them to get a bigger boost from the immediate expensing of capital expenditures.

The Losers

- The biggest losers will be companies that pay low effective tax rates currently, have substantial debt in their capital structure and low returns on capital.
- Though some of them may gain from the one-time release of trapped cash, that cash will most likely be returned to shareholders in the form of dividends and buybacks and there will be little benefit from new investments.

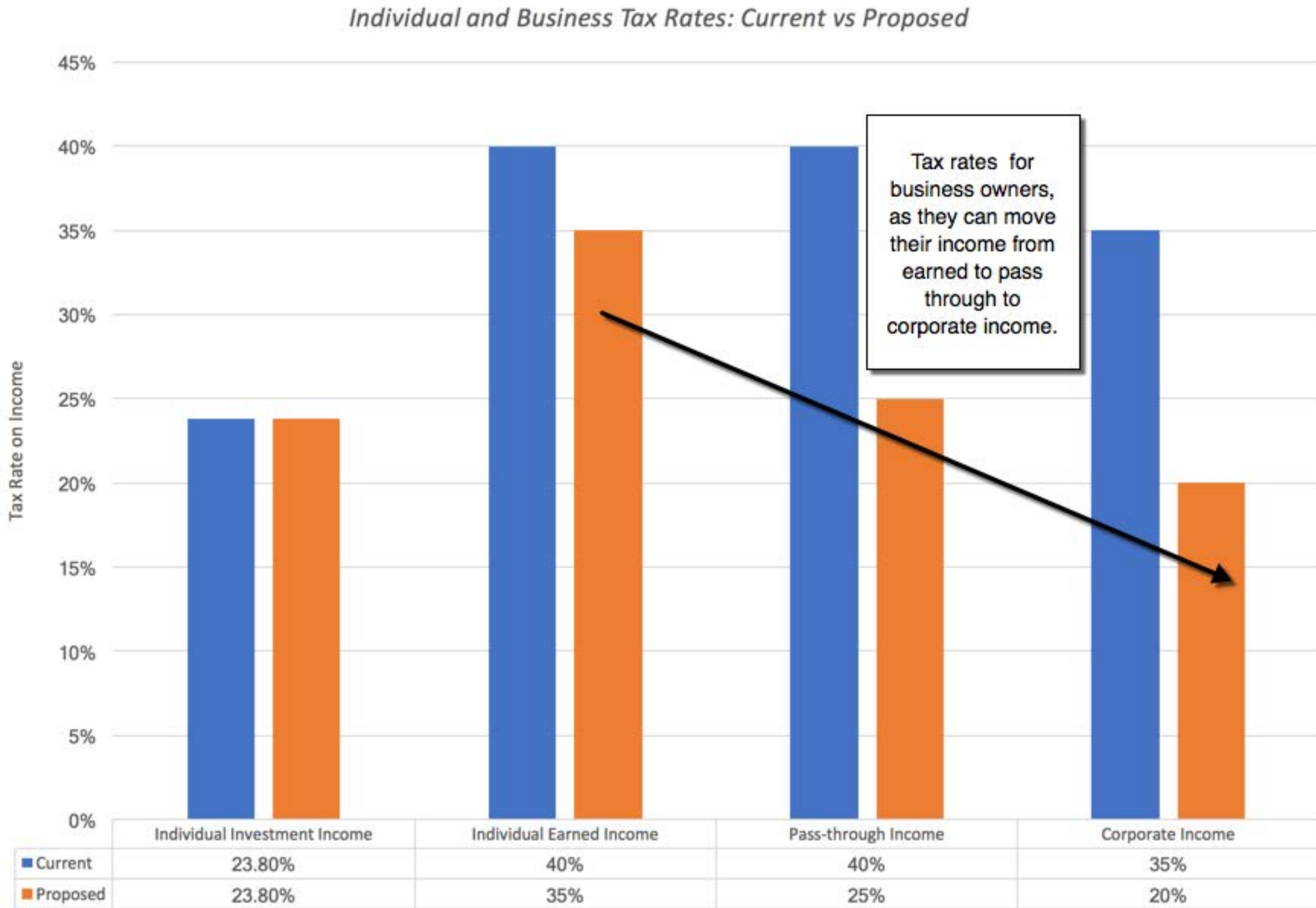
The Good News in this tax reform

- Realism on foreign income: By lowering the US statutory tax rate on corporate income towards that of most other industrialized countries and shifting from a global to a territorial tax system, the reform package moves the US towards a healthier system, where companies will spend less time on transfer pricing and managing trapped cash and more on core businesses.
- Debt tilt reduced: The changes that are designed to reduce the tax tilt towards debt are sensible and will hopefully shift the focus of corporate restructuring from recapitalization (where the bulk of the value comes from increasing debt) to real operating changes.

The Bad News: Part 1

- I understand the motives behind the immediate expensing of capital expenditures, for tax purposes, but it will make the gap between reporting books and tax books into a chasm.
- Companies will eagerly expense their capital investments, in their tax books, report low income and pay low taxes, but will keep to GAAP rules in their reporting books, with the only clue to the divergence being very low effective tax rates.

The Bad News: Part 2



	Individual Investment Income	Individual Earned Income	Pass-through Income	Corporate Income
Current	23.80%	40%	40%	35%
Proposed	23.80%	35%	25%	20%

Conclusion

- I think that we are vastly over due for tax reform in the US and the changes that this reform package make to foreign income taxation and the treatment of debt are good.
- The divergence in tax rates and the expensing of capital expenses though will create more game playing and make tax lawyers happy (and the rest of us will pay the price for that happiness).