CORPORATE TAX REFORM: YET AGAIN?

You are entitled to opinions, but not to the facts!

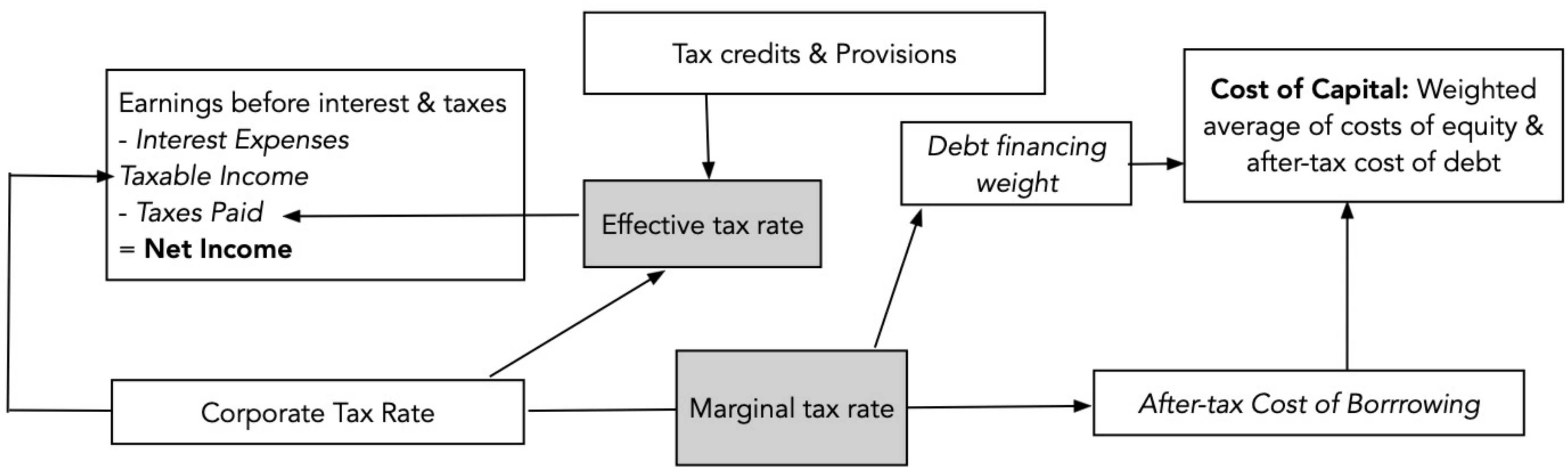
Another tax reform moment?

- The Biden Administration's $ 2 trillion infrastructure plan, announced with fanfare a few weeks ago, has seemed to have opened up a debate about not only what comprises infrastructure, but also about how to pay for it. Not surprisingly. it is corporate taxes that are the primary vehicle for delivering the revenues needed for the plan, with an increase in the federal corporate tax rate from 21% to 28% being the central proposal.
- I will leave the debate on what comprises infrastructure to others, and focus entirely on the corporate tax question in this post.
- I do this, knowing fully well that tax debates quickly turn toxic, as people have strong priors on whether corporations pay their fair share of taxes, and selectively find inforrmation to back their positions.

Taxes and Value: It is complicated

- Feedback effect on taxable income: This may seem cynical, but it is nevertheless true that the amount that companies report as taxable income and how much they choose to defer taxes into future years is a function of the corporate tax rate. As *tax rates rise*, corporations use the discretion built into the tax code to *report less taxable income* and to *defer more taxes* to future years. It is for this reason that legislatures around the world over estimate how much additional revenue they will generate, when they raise taxes, and investors over estimate how much corporate earnings will rise when tax rates are decreased.
- Contemporaneous changes in the tax code: When corporate tax rates are changed, it is a given that there will be other changes in the tax code that may either counter the change or add to it. For instance, the 2017 US tax reform act, in addition to lowering the corporate tax rate, also changed the way that foreign income to US companies was taxed.
- Financing Mix: Companies can raise capital either from equity or debt, and the costs of equity and debt can be altered when the tax rate changes. That is because interest on debt is tax deductible, and as the corporate tax rate rises, the after-tax cost of debt falls, making debt a more attractive financing option for companies.

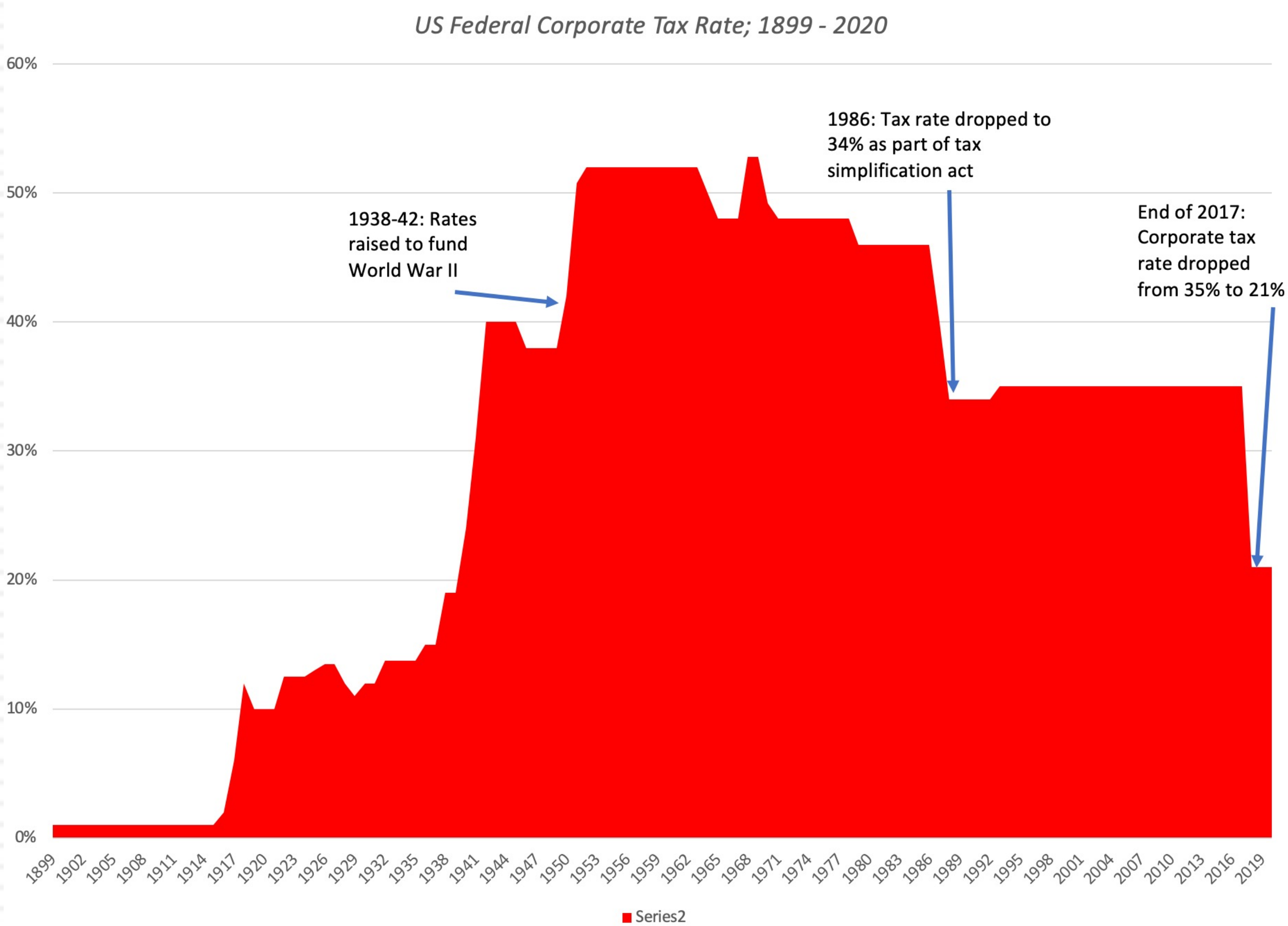
Taxes and Value: A Picture



Taxes and Value: Differentiating Factors

- Note that it is the effective tax rate, determined by tax deferrals and other tax management tools, that drives after-tax earnings and cash flows, and the marginal tax rate, i.e., the tax rate on the last dollar of income earned that determines the corporate after-tax borrowing cost. It is this reason that the effect of raising or lowering corporate tax rates on value can get murky, with the following general propositions:
  - <u>Tax Deferral Options</u>: Companies that have more options when it comes to deferring taxes than others can buffer the impact of higher corporate taxes by choosing to defer taxes and report less taxable income.
  - <u>Debt funding</u>: Firms that are heavier users of debt financing will be able to offset some or even all of the impact of a higher corporate tax rate, by using the tax advantages that come with the higher tax rate to lower their costs of capital.
- Put simply, when corporate tax rates are raised, not all companies will lose the same, and there may even be a few companies that emerge as net winners.

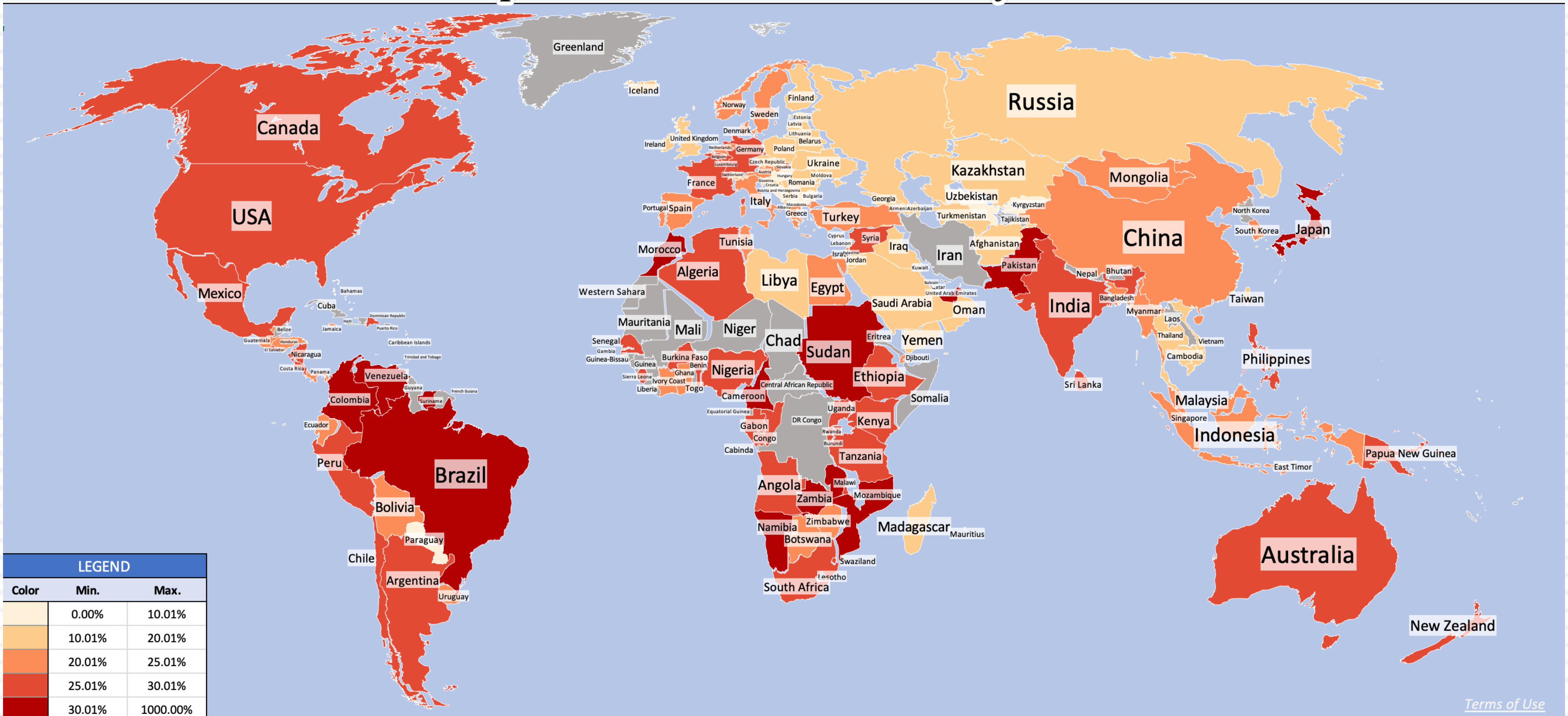
Marginal Tax Rates: US Corporate Tax Rates over history



But the world has changed..

- While that system worked well for most of the twentieth century, it started to break down towards the end of that century, as the US became a less dominant player in the global economy and other countries lowered their corporate tax rates. The first development meant that larger proportions of US corporate income was generated overseas, and the second increased the differential tax rates and thus the repatriation penalty.
- By 2014, when I wrote this post, the US tax code had become dysfunctional, as the trapped cash cumulated to trillions of dollars and some US companies sought to change move their incorporation to other countries.
- This history is worth emphasizing, because the change in the US corporate tax rate in 2021, from 35% to 21%, accompanied by the abandonment of the global tax model just brought the US closer to the rest of the world in terms of both tax rates and treatment of foreign income.

Corporate Tax Rates at the start of 2021

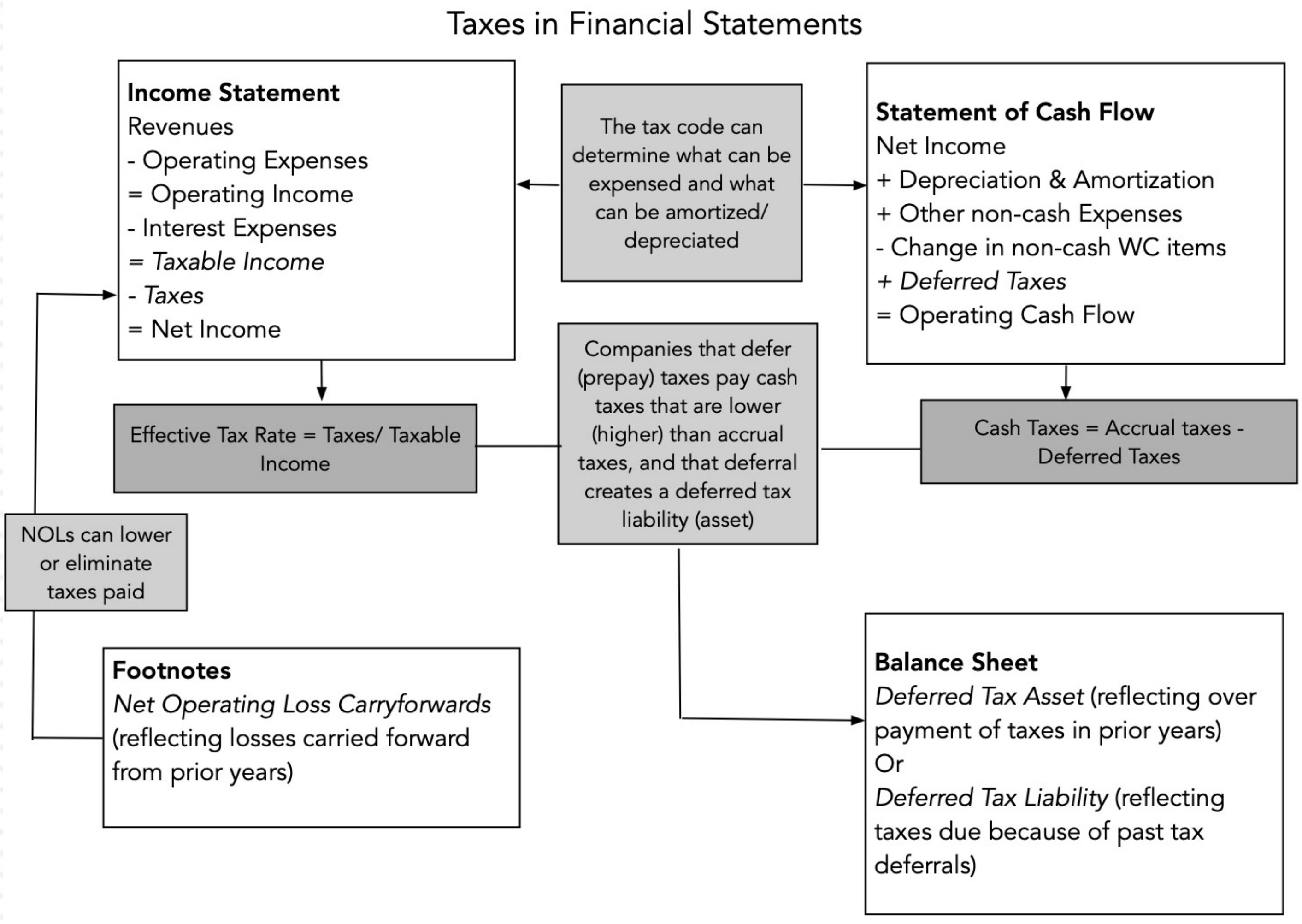


Country	2015	2016	2017	2018	2019	2020
United States	40.00%	40.00%	40.00%	27.00%	27.00%	27.00%
Africa	28.14%	28.03%	28.21%	28.26%	28.23%	28.25%
Americas	27.61%	27.71%	28.29%	28.11%	27.36%	27.33%
Asia	21.98%	21.41%	21.08%	21.21%	21.18%	21.13%
EU	22.15%	22.09%	21.33%	21.29%	20.98%	20.87%
Europe	20.05%	19.97%	19.53%	19.48%	19.26%	19.12%
Global	23.77%	23.62%	24.06%	24.05%	23.81%	23.79%
Latin America	27.16%	27.29%	27.98%	28.20%	27.39%	27.36%
North America	33.25%	33.25%	33.25%	26.75%	26.75%	26.75%
Oceania	27.00%	27.00%	28.43%	28.43%	28.43%	28.43%
OECD	24.77%	24.69%	23.95%	23.53%	23.23%	23.05%
South America	27.16%	27.29%	27.98%	28.20%	27.39%	27.36%

Effective Tax Rates

- To measure how much companies pay in taxes, you have to start with the financial statements of the company, recognizing that these are reporting documents, not tax documents.
- Put simply, what you see as taxable income in the annual report or public financial filing for a company can be very different from the taxable income in the tax filings made by the same company.
- Since we have no access to the latter, at least for individual companies, there are clues in the reported financials that can nevertheless help us assess how much a company pays in taxes

The Clues in the Financial Statements



Why effective tax rates can mislead..

- Accrual income: It is worth remembering that accrual income is after accounting expenses, some of which are related to operations (cost of goods sold, marketing), some to financial (interest expenses) and some of which are determined by the tax code (depreciation and amortization, write offs, special charges). A company that is savvy about using tax provisions to lower its accrual income may be able to look like it is paying a high effective tax rate, but is actually paying much less.
- Cash taxes versus Accrual taxes: The actual taxes paid by to the government (cash taxes) can be higher or lower than the accrual taxes, and the difference should be visible in the cash flow statement in the form of deferred taxes.
- Past tax behavior: One final aspect that can affect a company's tax burden is its past history. A company that has lost considerable amounts in prior years can accumulate net operating losses that can reduce taxes paid in the current period. In addition, a company that has deferred taxes in prior years will find itself playing catch-up and paying more in taxes in the current year, just as companies that have pre-paid taxes may be able to pay far less in taxes in the current year.

Measuring Tax Rates for a Group: Alternative measures

- Taxes paid in dollar value (Accrual and Cash): This reflects the aggregate amount paid by all companies in a grouping during the most recent year. Ultimately, this is the number that matters most from a tax collection perspective.
- Average effective tax rate across all companies: This is the average tax rate across all companies in a grouping, including money losing companies. Not surprisingly, the average will be pushed down as the number of money losing firms increases.
- Average effective tax rate across money making companies: This deals with the problem of money losing companies, but it is a simple average and it weights very small companies and very large companies equally.
- Aggregate tax rate: This is the tax rate that best captures how much companies pay in a sector, and is computed by dividing the sum of taxes paid by all companies in a sector by the sum of taxable income. It thus weights companies that are bigger more than smaller companies.

US Effective Tax Rates: 2016 - 2020

Change in % tax rates from 2017 to 2019
After the change in tax rates at the end of 2017, the effective and cash tax rates for US companies dropped from pre-reform levels, with the former dropping 6.08% and the latter about 2.75%.

Change in corporate tax rate from 35% to 21%

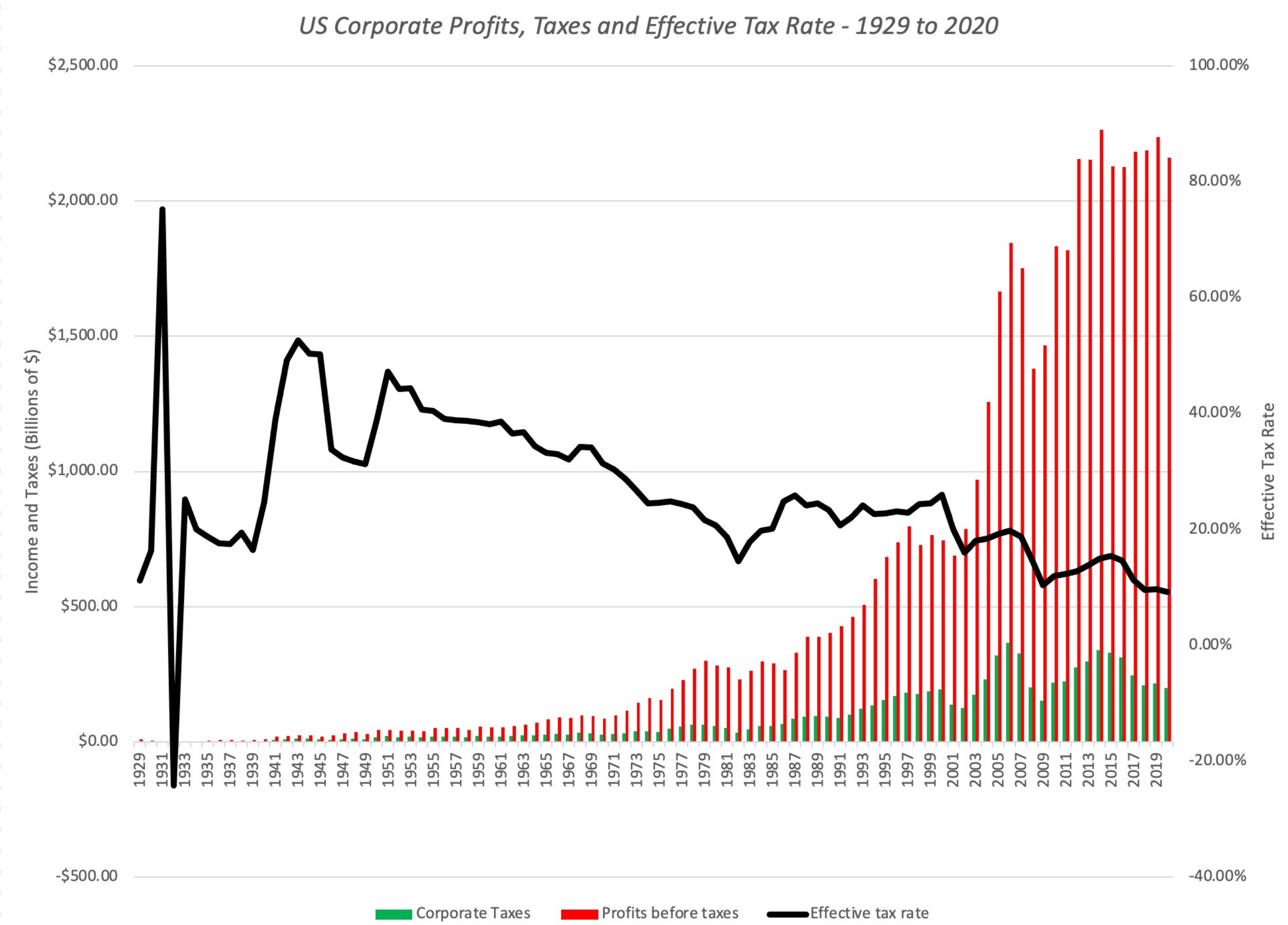
Year	*Revenues*	*Taxable Income*	*Accrual Taxes*	*Cash Taxes*	*Effective Tax Rate*	*Cash Tax Rate*	*Taxable Income/Revenues*
2016	$14,070,979	$1,236,508	$352,265	$302,300	28.49%	24.45%	8.79%
2017	$14,317,185	$1,342,101	$330,802	$283,496	24.65%	21.12%	9.37%
2018	$15,462,865	$1,880,466	$514,823	$321,498	27.38%	17.10%	12.16%
2019	$16,079,001	$1,806,300	$335,446	$331,899	18.57%	18.37%	11.23%
2020	$15,892,607	$1,563,257	$277,635	$333,797	17.76%	21.35%	9.84%

In 2018, tax rates were skewed by companies taking advantage of one-time tax on return of trapped cash

Change in $ values from 2017 to 2019

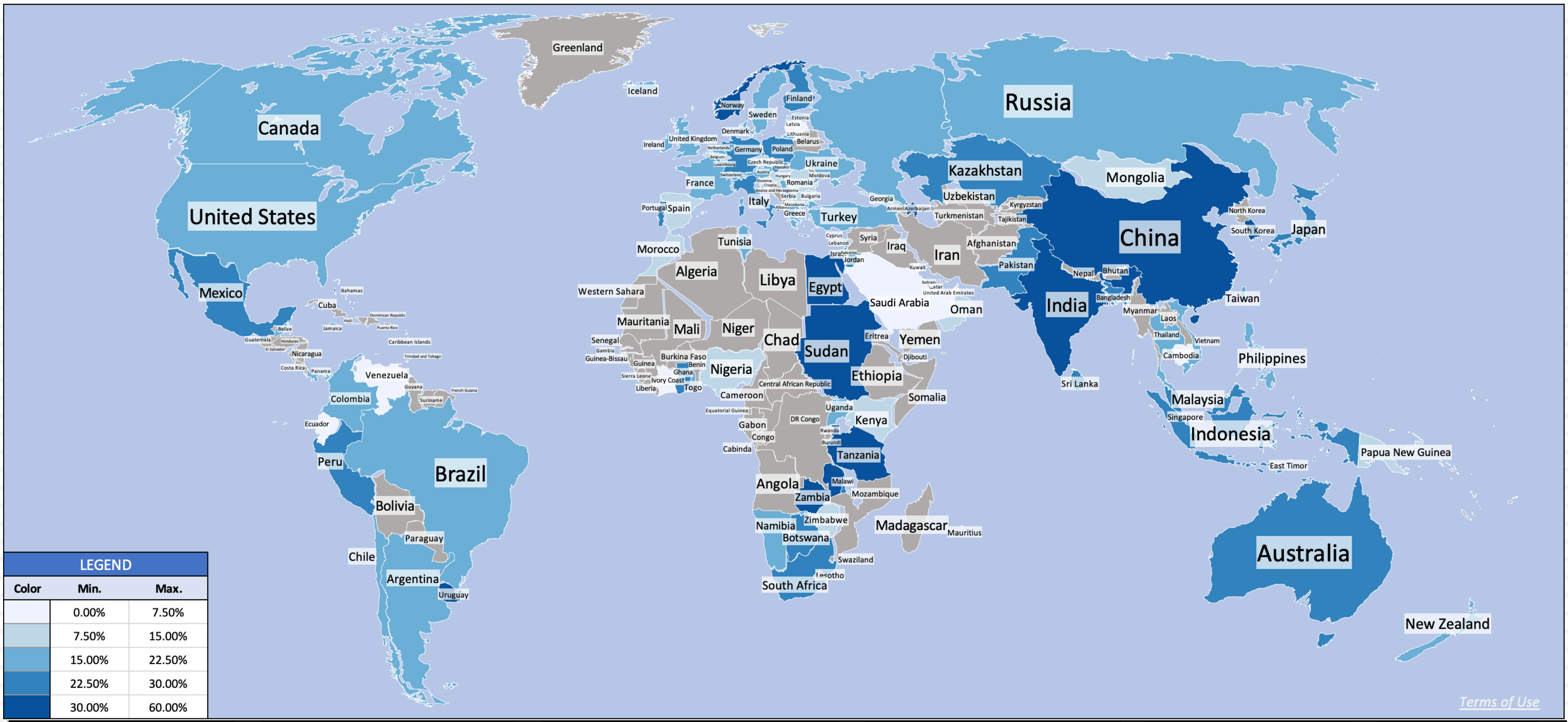
	Revenues	*Taxable Income*	*Accrual Taxes*	*Cash Taxes*
2019 vs 2017	12.31%	34.59%	1.40%	17.07%

And over time…



Effects of lowering marginal tax rates?

- Note that while the corporate tax rate dropped by 14% (from 35% to 21%) from 2017 to 2018, the effective tax rate decreased by 6.8% and the cash tax rate by 2.75%.
- In a more telling statistic, the dollar value of taxes paid increased between 2017 and 2019 by 1.4% and cash taxes by almost 18%, as companies reported more taxable income.
- While the argument about the right tax rate for companies is a legitimate one, it has to start with a reality check. The widely held perception that US companies are now paying less in taxes than they were prior to 2017, while it may fit your preconceptions about corporate tax behavior, is not backed up by facts.



Sub Region	Total Taxable Income	Total Taxes Paid (Accrual)	Total Cash Taxes Paid	Effective Tax Rat	Cash Tax Rat
Africa and Middle East	$357,092.67	$120,562.18	$23,469.66	33.76%	6.57%
Australia & NZ	$102,919.27	$29,061.43	$29,525.97	28.24%	28.69%
Canada	$174,469.92	$32,864.43	$30,177.88	18.84%	17.30%
China	$1,192,229.28	$250,261.59	$435,933.09	20.99%	36.56%
Eastern Europe & Russia	$118,735.39	$23,806.87	$22,748.65	20.05%	19.16%
EU & Environs	$1,000,311.30	$237,474.52	$197,561.88	23.74%	19.75%
India	$143,004.69	$38,458.45	$45,431.55	26.89%	31.77%
Japan	$568,242.50	$157,590.09	$160,786.11	27.73%	28.30%
Latin America & Caribbe	$191,540.12	$40,009.53	$32,080.93	20.89%	16.75%
Small Asia	$426,384.65	$97,302.66	$110,572.43	22.82%	25.93%
UK	$220,869.42	$51,194.99	$46,753.91	23.18%	21.17%
United States	$1,806,300.20	$335,446.32	$331,898.81	18.57%	18.37%
Global	$6,302,099.39	$1,414,033.06	$1,466,940.86	22.44%	23.28%

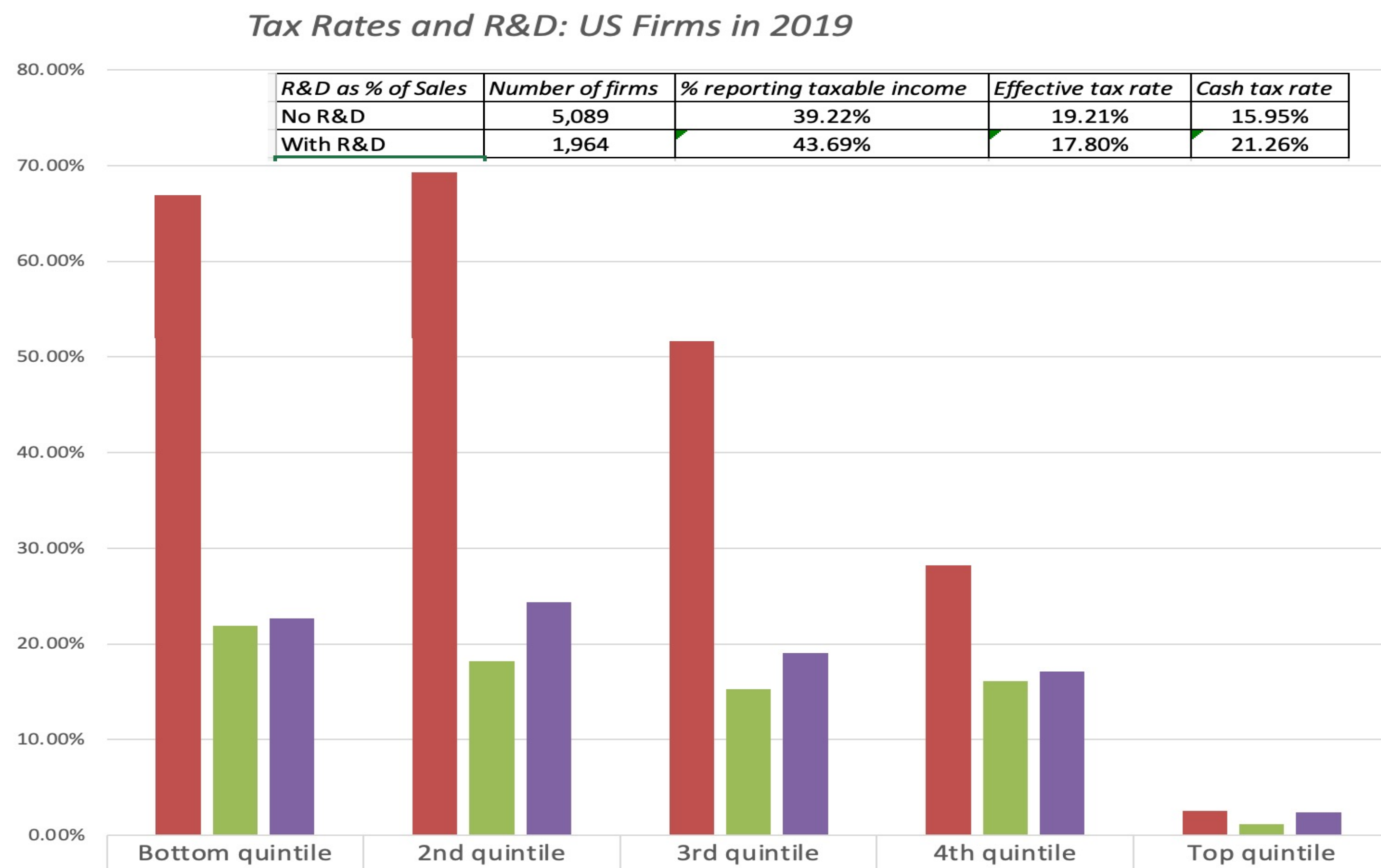
Sector Specific Tax Rates: For US

Industry name	*Aggregate tax rate*	*Industry name*	*Aggregate tax rate*	*Industry name*	*Aggregate tax rate*	*Industry name*	*Aggregate tax rate*	*Industry name*	*Aggregate tax rate*
R.E.I.T.	1.24%	Auto Parts	14.78%	Insurance (Prop/Cas.)	19.67%	Construction Supplies	22.21%	Recreation	26.33%
Steel	3.07%	Beverage (Alcoholic)	15.08%	Financial Svcs. (Non-bank & Insurance)	19.69%	Shipbuilding & Marine	22.83%	Chemical (Basic)	26.98%
Broadcasting	4.05%	Shoe	15.30%	Hospitals/Healthcare Facilities	19.82%	Chemical (Diversified)	22.85%	Education	28.74%
Software (System & Application)	4.34%	**Total Market (without financials)**	**15.64%**	Paper/Forest Products	19.84%	Building Materials	22.99%	Oil/Gas (Integrated)	30.06%
Healthcare Products	4.68%	Oil/Gas (Production and Exploration)	15.69%	Insurance (Life)	19.84%	Air Transport	23.04%	Tobacco	30.27%
Auto & Truck	6.30%	Apparel	15.77%	Brokerage & Investment Banking	19.88%	Healthcare Support Services	23.07%	Engineering/Construction	37.33%
Drugs (Biotechnology)	6.53%	**Total Market**	**16.38%**	Utility (Water)	19.96%	Farming/Agriculture	23.16%	Metals & Mining	40.21%
Food Processing	6.75%	Investments & Asset Management	16.66%	Insurance (General)	20.02%	Homebuilding	23.19%	Rubber& Tires	41.97%
Software (Internet)	8.16%	Software (Entertainment)	16.73%	Cable TV	20.22%	Transportation (Railroads)	23.38%		
Computers/Peripherals	8.46%	Electronics (General)	17.61%	Restaurant/Dining	20.30%	Retail (Special Lines)	23.46%		
Semiconductor	11.57%	Bank (Money Center)	17.74%	Real Estate (General/Diversified)	20.31%	Retail (Distributors)	23.68%		
Business & Consumer Services	11.87%	Diversified	17.92%	Banks (Regional)	20.31%	Retail (Automotive)	23.86%		
Heathcare Information and Technology	11.89%	Telecom. Services	18.08%	Reinsurance	21.03%	Retail (General)	24.10%		
Entertainment	12.29%	Information Services	18.65%	Real Estate (Operations & Services)	21.10%	Retail (Grocery and Food)	24.12%		
Semiconductor Equip	12.49%	Environmental & Waste Services	18.82%	Oil/Gas Distribution	21.31%	Retail (Building Supply)	24.44%		
Retail (Online)	13.06%	Aerospace/Defense	18.89%	Telecom. Equipment	21.35%	Precious Metals	24.46%		
Drugs (Pharmaceutical)	13.46%	Electrical Equipment	18.97%	Telecom (Wireless)	21.50%	Household Products	24.83%		
Food Wholesalers	13.55%	Machinery	19.17%	Office Equipment & Services	21.56%	Chemical (Specialty)	25.14%		
Utility (General)	13.93%	Real Estate (Development)	19.35%	Furn/Home Furnishings	21.66%	Advertising	25.72%		
Hotel/Gaming	14.56%	Transportation	19.65%	Packaging & Container	21.82%	Computer Services	26.05%		

Reading the tea leaves..

- There are clear differences in taxes paid across sectors, with some of the reasons being obvious (REITs are pass through entities that pay no federal taxes) and some not.
- For instance, technology companies and pharmaceutical businesses are mostly in the first two columns (with the lowest tax rates) and retail companies pay much higher tax rates.
- Pharmaceutical and technology companies do share a common characteristic, which is that their primary capital expenditure takes the form of R&D, which has historically been expensed at these companies, rather than capitalized and depreciated.

R&D and Taxes



R&D as % of Sales	*Number of firms*	*% reporting taxable income*	*Effective tax rate*	*Cash tax rate*
No R&D	5,089	39.22%	19.21%	15.95%
With R&D	1,964	43.69%	17.80%	21.26%

	Bottom quintile	2nd quintile	3rd quintile	4th quintile	Top quintile
% reporting taxable income	66.84%	69.21%	51.65%	28.24%	2.54%
Effective tax rate	21.85%	18.16%	15.26%	16.08%	1.13%
Cash tax rate	22.63%	24.38%	19.07%	17.15%	2.35%

Market Cap and Taxes

There seems to be a perception that it is the largest companies that are not paying their fair share in taxes, fed by anecdotal evidence of high profile companies that pay no taxes; in the last few years, those examples have included GE, Amazon and FedEx.

Market Capitalization	Number of firms	$ Taxable Income	$ Taxes	$ Cash Taxes	% reporting taxable income	Effective tax rate	Cash tax rate
Bottom decile	702	$15.40	$0.00	$0.54	1.00%	0.00%	3.51%
2nd decile	708	$73.55	$0.01	$0.54	3.81%	0.01%	0.74%
3rd decile	705	$60.52	$7.38	$24.59	6.10%	12.19%	40.62%
4th decile	705	$703.97	$41.64	$72.85	17.73%	5.91%	10.35%
5th decile	706	$1,337.93	$268.39	$199.29	38.95%	20.06%	14.90%
6th decile	705	$5,035.91	$828.09	$1,081.11	47.38%	16.44%	21.47%
7th decile	706	$14,873.50	$2,847.11	$2,827.18	56.09%	19.14%	19.01%
8th decile	705	$55,476.92	$8,417.15	$7,881.64	66.10%	15.17%	14.21%
9th decile	705	$131,693.60	$27,447.08	$23,471.25	79.15%	20.84%	17.82%
Top decile	706	$1,597,028.90	$295,589.47	$296,334.72	88.24%	18.51%	18.56%

Thoughts on new tax laws

- Get your mission right: In keeping with the saying that if you do not know where you going, it does not matter how you get there, the starting point for all tax legislation has to be with the end game. Early on, legislators have to decide whether they consider corporate taxes to primarily a source of revenues to the government or a weapon to punish "bad" corporate behavior and to "reward" good corporate behavior.
- All tax talk is agenda-driven: Economists and experts will use numbers that back their arguments and look like facts, but it is easy to lie with numbers, especially when it comes to taxes.
- Focus on removing tax deductions/credits, not on increasing tax rates: If the end game is to get companies to pay more in taxes, removing tax deductions and credits will be more effective than increasing the tax rate. In fact, raising the tax rate will not only raise the effective tax rate paid by companies far less than expected, but it will also have disparate effects across companies.
- Remember that you operate in a global economy: No matter how careful you write the tax laws, multinationals will retain a substantial amount of freedom to move their operations and income around the world. A country that is an outlier when it comes to taxes, as the United States was prior to 2017, will lose out in the competition for new businesses.
- Provide long-term predictability: Whatever Congress decides to do with the tax code, it should also provide a degree of predictability for an extended period. Changes to the tax law that are temporary or come with sunset provisions create uncertainty for businesses trying to make investment decisions for the long term.