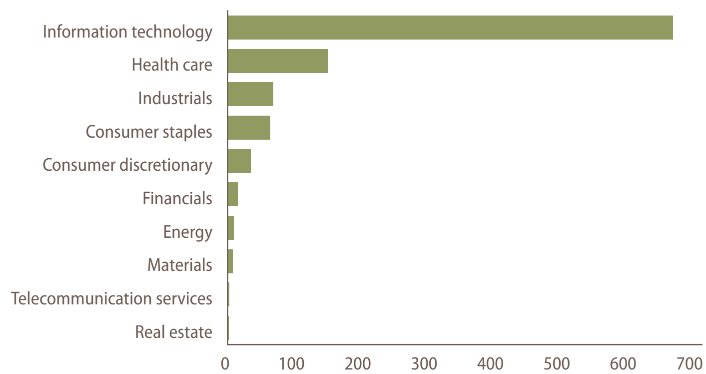
Tax Reform—Overseas Cash and Repatriation Implications

Prereform tax laws resulted in large overseas cash balances

Prior to 2018, the United States' relatively high corporate tax rate incented many domestic companies with international operations to locate foreign subsidiaries in tax-haven countries and delay U.S. tax payments. Under the prereform tax code, these foreign subsidiaries were subject to the same 35% maximum federal statutory corporate tax rate as their domestic counterparts, with income taxes being levied on those profits when foreign cash was repatriated, or returned, to the United States. Foreign subsidiary income that remained overseas was recorded with a deferred tax liability on parent financial statements, but no cash was paid out for U.S. taxes. The foreign subsidiary typically paid taxes to the country of domicile at the prevailing overseas tax rate, resulting in an overall lower U.S. effective corporate tax rate—currently estimated at 18.6%. To offset double taxation, the corporation claimed a foreign tax credit when cash was repatriated to the U.S., so the total taxes owed to the U.S. were net of foreign taxes already paid.

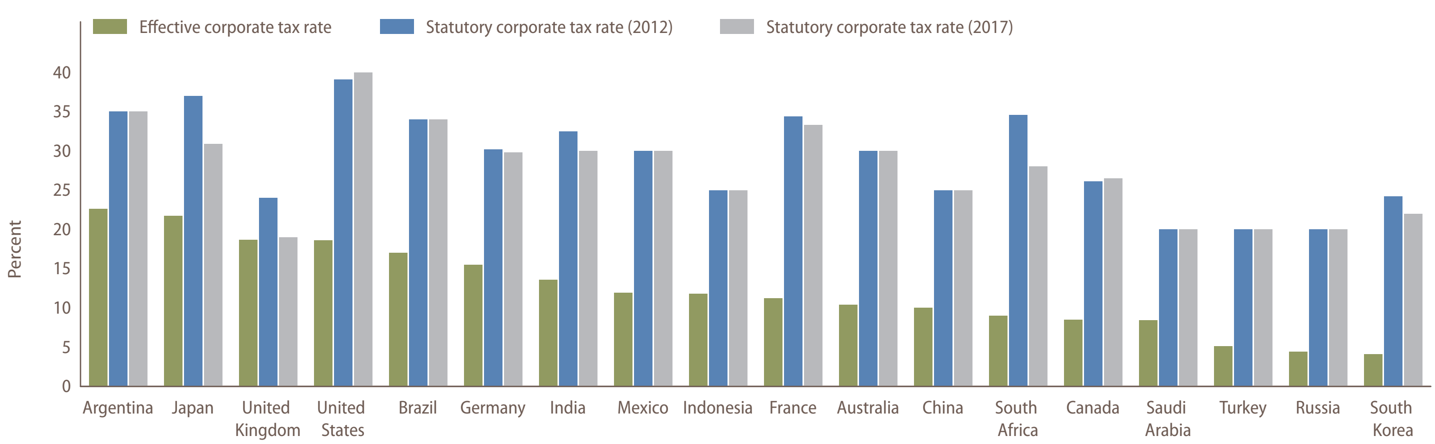
In the face of high barriers to repatriation, overseas cash balances have accumulated since the last repatriation holiday in 2004 because cash has not been needed for general corporate purposes, such as domestic acquisitions, capital investments, or dividend payments, due in large part to easy and relatively cheap access to capital markets. Estimates show that untaxed overseas cash and cash equivalents total approximately $1.022 trillion. The information technology ($671 billion) and health care ($151 billion) sectors account for 80% of total S&P 500 Index untaxed overseas cash, and the top 20 companies with the most overseas cash account for $835 billion, or 82%, of total S&P 500 Index overseas cash. In examining the investments of those 20 companies, about 36% of the overseas cash is invested in corporate notes and bonds, with another 29% invested in U.S. Treasury and agency securities.

Overseas cash balances of S&P 500 Index companies by sector ($ billions)



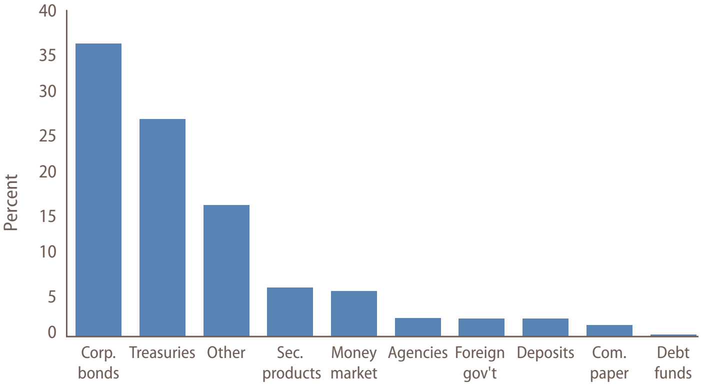
Sources: Bloomberg L.P. and 2017 company filings

Effective corporate and statutory income tax rates from select G20 countries



Sources: Bloomberg L.P. and Congressional Budget Office

Portfolio allocation for U.S. companies with significant overseas cash holdings



Sources: Bank of America and 2017 company filings

Reforming international taxation

The intended goal of the 2017 tax reform bill as it relates to international taxation is to level the playing field for multinational corporations and reduce the incentive for U.S.-based corporations to locate operations abroad. By reducing statutory corporate tax rates and incentivizing corporations to repatriate cash, the U.S. government hopes to increase job growth and business investment, push wages higher, and boost U.S. gross domestic product.

The new tax law will significantly change the way the U.S. taxes international activity, moving the tax system away from a global approach and closer to a territorial one, which is more similar to the majority of our trading partners. Generally, income will be taxed by the nation where the income is produced, regardless of the country of domicile. This new approach means that U.S. companies will no longer owe U.S. taxes on income earned abroad, while the income earned in the U.S. by foreign companies will face U.S. taxes.

While future foreign earnings will generally not be subject to U.S. taxes, foreign earnings prior to 2018—those not yet brought back to the U.S. and therefore not yet taxed—will not escape taxation, as this corporate tax overhaul comes with a one-time tax on prior income currently stranded overseas. The new law taxes all prior earnings at 15.5% on earnings held overseas in liquid investments and at 8% on earnings that have been reinvested in more permanent assets such as property or equipment. And since the tax is levied whether or not the earnings are repatriated, companies are free to leave or move the money as it suits them.

The question occupying most observers is what will happen with all of the overseas cash under the new tax law and its deemed repatriation tax? A good starting point is to examine corporate behavior following the last repatriation holiday. In 2004, Congress passed the American Jobs Creation Act of 2004; it provided a repatriation holiday for overseas earnings of multinational companies by excluding 85% of repatriated earnings from taxation, provided certain capital expenditure measures were met. In addition to the stimulus provided by increasing corporate investment expenditures, it was also intended to increase jobs by 500,000 over two years, based on the premise that companies were capital-constrained by having to keep earnings overseas. And, indeed, corporations confirmed this premise in a confidential survey prior to enactment, in which they stated proceeds would be used for venture capital and acquisitions purposes and to pay down debt and increase capital spending and research and development funding.

In practice, repatriated earnings in the year following enactment exceeded most expectations, running at about 40% of overseas earnings and totaling about $300 billion, a five-fold increase from the previous five-year average. With an average effective tax rate of 5.25%, it was clear this was an attractive proposition. However, uses intended by the legislation did not materialize. Although expressly prohibited, the vast majority of repatriated earnings—92% of every dollar—went to share repurchases and, to a lesser extent, dividends in the guise of capital that had been "freed up" by repatriation; less than 1% was invested in capital expenditures. It appears corporations viewed this as a rare event unlikely to reoccur, and so were loathe to indulge in activities that could be misconstrued as permanent or semipermanent. In addition to shareholder payouts, companies repatriating $259 billion also engaged in round-tripping of repatriated earnings, meaning after paying taxes on foreign earnings, they then repaid the money to foreign affiliates in the form of additional paid-in capital to the tune of $104 billion, or 40%, of those earnings.

Lessons learned from 2004 were that corporations were not constrained from reinvesting earnings, either here or abroad. Indeed, average borrowing costs were relatively low during the period, and yet capital investments did not rise, leading to the conclusion that opportunities did not exist and/or could be funded through domestic earnings and domestic capital raises. Also, dollars kept abroad may have benefited from a lower tax rate but also could have been left there for future capital expenditures, especially in light of round-tripping behavior indulged in by domestic corporations. And finally, corporate behavior suggests they viewed this event as nonrecurring and so they treated the proceeds accordingly by rewarding equity stakeholders.

Top 20 S&P 500 Index companies ranked by overseas cash balances ($ billions)

Name	Sector	Overseas cash balance	Percent
Apple Inc.	Information technology	252	30.2
Microsoft Corp.	Information technology	128	15.3
Cisco Systems, Inc.	Information technology	68	8.1
Oracle Corp.	Information technology	54	6.5
Alphabet Inc.	Information technology	52	6.2
Johnson & Johnson	Health care	41	4.9
General Electric Co.	Industrials	39	4.6
Amgen Inc.	Health care	36	4.3
QUALCOMM Inc.	Information technology	29	3.5
Gilead Sciences, Inc.	Health care	27	3.3
The Coca-Cola Co.	Consumer staples	20	2.4
PepsiCo. Inc.	Consumer staples	15	1.8
The Procter & Gamble Co.	Consumer staples	15	1.8
Intel Corp.	Information technology	14	1.6
Franklin Resources, Inc.	Financials	9	1.0
Amazon.com, Inc.	Consumer discretionary	9	1.0
Bristol-Myers Squibb Co.	Health care	8	1.0
Visa Inc.	Information technology	7	0.8
Celgene Corp.	Health care	6	0.7
Medtronic plc	Health care	6	0.7
Total		**$835**	

Sources: Bloomberg L.P. and 2017 company filings

Potential market impacts

Because this time around is not like the last repatriation, we think the impact to U.S. markets will be minimal, primarily because taxation of foreign profits will occur whether or not the cash is actually repatriated into the U.S., and the changes to the tax structure are permanent. With companies having easy access to capital markets in the past 13 years, there seems to be very little impetus to bring money home to make more capital investments. To the extent the taxation frees up cash to come home, it is likely corporate behavior will mirror the past and they will reward shareholders through share repurchases or special dividends.

So what becomes of the cash holdings overseas? In analyzing the potential impact of these flows on the U.S. money markets, it is important to remember that the holders of offshore cash are sophisticated money managers themselves, with access to generally all the investment options abroad that they would have in the U.S. Put another way, the money is already largely invested in the short-term securities the holders want to own, and it seems likely it will end up in those same investment categories after it is moved. If that is how it plays out, it seems any impact on the money markets will be obscured by whatever other supply and demand factors are moving around the vast money markets.

That said, while the overseas money has been sitting and growing since 2004, the U.S. money markets have changed significantly over the past several years. The regulatory changes for money market funds (MMFs) that took effect in 2016 made prime MMFs less appealing to large institutional investors—the same types of companies as the potential repatriators—pushing about $1 trillion from prime MMFs to government MMFs. To the extent some of the overseas money is currently invested in prime-type instruments and the companies want to park the money temporarily in the U.S. pending further deployment, it may end up in government MMFs, resulting in slightly less demand for prime instruments and greater demand for government securities.

If there is a marginal boost to demand for government investments, it looks to come at a time when it may be easily absorbed by increased supply, as the U.S. Treasury is expected to fund its additional needs in 2018 with greater Treasury bill supply. In addition to the Treasury's desire to build its cash balance to a higher level and its need to replace securities due to the Fed's shrinking balance sheet, it must also fund the tax-cut package, of which the foreign tax changes and repatriation are a part.

The largest long-term impact of repatriation could well be an asset allocation shift out of fixed income and into equities in the form of dividends, share repurchases, or possibly even mergers and acquisitions involving other public companies. This may lead to higher equity prices and a positive impact on household wealth and discretionary spending; at the same time, the impact on credit markets may be mixed. For example, if multinational companies no longer have a need to issue debt for corporate purposes (such as dividend payments), we may see less issuance, especially in the tech and biotech sectors. This could lead to a decrease in the overall supply of corporate securities. At the same time, a decrease in balance sheet debt typically strengthens a corporation's financial position; this could lead to an improvement in the overall credit quality of corporate issuers.

One thing that seems to be certain is that cash balances will shrink. The one-time deemed repatriation tax must be paid and we know it will total 15.5% of the approximately $1 trillion in cash trapped overseas. And then there is the tax due on profits that have been reinvested, the amount of which is not known. A simple Google search reveals estimates of total foreign untaxed profits ranging from $1.6 trillion to $2.1 trillion, which would mean an additional 8% tax on a base ranging from $600 billion to $1.1 trillion. How companies choose to pay this roughly $250 billion tax bill, whether through corporate earnings, domestic or international cash balances, or a combination, remains to be seen and will ultimately drive the amount by which foreign balances shrink. And as to the timing of those flows, corporations may opt to pay the balance due either up front or in eight installments, so the timing also is uncertain. While many multinational companies have been some of the largest investors in fixed-income securities in recent years, in the future, their sophisticated investment staffs likely will continue to invest firm money in similar securities, albeit in a reduced capacity. With the Federal Reserve seemingly intent on continuing to raise the benchmark lending rate, this could mean more attractive all-in yields in the future.

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