How can finance executives walk the tax reform tightrope?

Making capital allocation decisions in light of US tax reform

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The recent Tax Cuts and Jobs Act (the Act) will have immediate and long-term implications on capital structure, capital allocation and performance measurement and forecasting. These implications are primarily driven by a much lower nominal corporate tax rate, changes to credits and deductions for businesses and individuals, and a modified territorial system for overseas earnings.

The following are answers to some of the top questions that finance executives should be considering.

How will the decrease in the corporate tax rate and limitation on the deductibility of interest expense affect our capital structure?

The decrease in the US corporate tax rate increases the effective cost of debt due to the lower tax benefit. Therefore, these provisions effectively make high levels of leverage less attractive, causing companies to reassess their optimal level of debt. In addition to the lowering the overall benefit amount, the Act's provisions generally limit the deductibility of net interest expense to 30% of tax-based EBITDA (after 2021, deductibility will be based only on EBIT), effectively penalizing higher levels of leverage. Certain real estate businesses are generally exempt from these limitations, and certain farming businesses may also be exempt. EY preliminarily estimates that the amount of debt held by public companies could decrease by as much as 25%. A number of factors – e.g., a company's financial position, risk preference, company and industry attributes – drive a company's optimal capital structure. Companies should also be aware of how peers' capital structure changes could affect the competitive landscape.

Potential actions:

- If you have a flexible capital structure, you may want to consider more aggressive actions to improve market position.
- Reassess how you price and structure investments or acquisitions.

Does the Act affect only US debt?

No, companies should re-evaluate their entire global financing structures. The effective limitations on high amounts of leverage in the US, combined with new provisions on the treatment of foreign income and dividends and the repatriation of foreign earnings may change the effectiveness of current financing and organizational structures.

Potential actions:

- Consider sources of funding through your global structure; you may have the potential for intercompany lending from the US or repaying external debt in the US while incurring debt directly at the foreign subsidiary level.
- Consider how the excess borrowing capacity of your foreign acquisitions could be utilized for intercompany lending.

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If the Act makes debt less attractive, are there options for raising capital besides issuing equity?

Yes, alternative financial instruments, such as sale/leaseback transactions, transfers to tax-advantaged real estate holding companies or issuance of preferred stock, may have newfound relevance given their debt-like attributes; and they may give companies flexibility in raising new capital given the effective limitations on leverage. The applicability and cost-effectiveness of alternative financial instruments will vary by company.

Potential actions:

- Consider leasing your assets, such as land or buildings, or outsourcing your nonessential services to third parties.
- Your investor relations department will likely play an important role in the use of alternative financial instruments, as this strategy will require explaining the impact and benefit to investors and analysts.

If we can expense 100% of certain US capital expenditures, should we approve all projects with a positive net present value or simply lower the hurdle rate?

Companies' ability to expense 100% of certain US personal property for the next few years will likely lead to value-destructive projects if companies overly rely on bonus depreciation to rationalize projects or simply increase spending across the board. Although the tax benefit associated with the bonus depreciation effectively increases project value, the benefit may be limited in certain circumstances due to new net-operating-loss limitations. Also, companies should effectively deploy capital to create sustainable value and avoid incentivizing the funding of marginal projects or inadvertently discounting downside risk. In order to maximize value creation, companies should thoroughly evaluate all investment decisions using formalized, replicable processes such as portfolio analyses that not only assess each individual project but also the highest potential value creation among a combination of projects.

Potential actions:

- Carefully consider a risk/reward or value creation framework in assessing projects, expansions or acquisitions, or you may experience future impairments or write-offs.
- Depending on your company's sector, consider increasing focus on fixed asset heavy companies as acquisition targets. There may be an overall increase in the proportion of transactions structured as asset acquisitions.

How can we assess the right capital strategy for our company? We've heard that many companies are going to use repatriated cash to pay dividends, buy back stock or repay debt.

The most advantageous and value accretive use of repatriated cash will be specific to each company and should be quantified — for example, by using strategic valuation models. Shareholders and activist investors will likely push for dividends or stock buy-backs, but companies may also want to consider the following options: capital structure/credit profile optimization in conjunction with debt repayment, organic growth (market or capacity expansion) and inorganic growth (strategic M&A). Ultimately, companies also need to provide support of their decision to shareholders through both a strategic and value creation point of view and need to show that they have considered all nuances. For example, if repatriated cash is used for an acquisition that can be structured as an asset sale, the US-qualified personal property may be able to be fully expensed, creating an added tax benefit (goodwill, intangible assets and non-US property will be subject to existing/local amortization requirements).

Potential actions:

- If you make an acquisition, put extra focus on executing identified synergies; market participants competing for acquisitions will likely drive up purchase prices, putting more pressure on achieving synergies.
- Take note of activist investors that may take positions in companies that have significant amounts of offshore cash with the goal of forcing buy-backs or one-time dividends.

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