Discussant Comments:

Danielle Green and Jon Kerr

How Do Firms Use Cash Tax Savings?

A Cross-Country Analysis

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Financial Reporting and Auditing Session

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Overview of the Paper

- ***Research question***: How do firms use cash tax savings?

Overview of the Paper

- *Findings*:
  - When deciding between using cash tax savings for investment or dividend payments, firms are more likely to invest cash tax savings rather than distribute them in the form of dividends.
  - These results hold for both multinational firms and international domestic-only firms.
  - Firms in weak governance countries are more likely to use tax savings to fund investment and pay dividends.

Overview of the Paper

- *Timeliness of the topic*: What are corporations doing with cash savings from changes in tax rates has become a fundamental question post-TCJA.

Overview of the Paper

During fiscal year 2018, we [Microsoft] recorded an estimated … charge … related to the TCJA, due to the impact of the ***one-time transition tax on the deemed repatriation of deferred foreign income of $17.9 billion*** *…*

The $120 billion question (net of residual U.S. tax):

Will MSFT repatriate these funds back to the United States and, if so, how will the company use them?

- Stock buy-backs?
- Increased dividends to shareholders?
- Increased compensation to management?
- Increased compensation to employees?
- Pay down U.S. debt?

Overview of the Paper

- The $1.2 trillion question

Companies Pay Down Debt with Cash Freed Up by New Tax Law

By Tatyana Shumsky, Nov. 13, 2018, WSJ

Tax-Cut Split: Consumers Are Spending but Businesses Curb Their Enthusiasm

By Justin Lahart, Nov. 9, 2018, WSJ

Tax Cuts Provide Limited Boost to Workers' Wages

By Vanessa Fuhrmans, Oct. 2, 2018 , WSJ

Overview of the Paper

Fed Paper Says Repatriated Profits Going Mostly to Shareholders

By Christopher Condon, Daily Tax Report

Many firms plan to use cash from tax cuts for M&A

By Bridget Walsh, EY Global Head of Transaction Tax, August 30, 2018

Overview of the Paper

How do firms budget for cash tax savings

For capital investment decisions we use classic WACC (weighted average cost of capital) analysis that includes the after tax cost of capital. The challenge with that is what tax rate to use. Options include a global average rate. That ignores the tax consequences of repatriation from unremitting foreign operations and of course ignores the concept of marginal tax rates; at what rate will an incremental dollar of profit be taxed. Assuming that a fixed amount of R&E tax credit will continue indefinitely with incremental profit will understate the actual tax on new profit.

Overview of the Paper

So clearly a marginal rate is best for WACC. The other issue is for non U.S. based investments. If the Chinese rate is 20%, do you use that rate. What about incremental withholding taxes on repatriation as well as U.S. consequences like GILTI, BEAT, etc. If you add these taxes to the ETR you run the risk of overstating the tax costs if repatriation doesn't happen until some future date. Our most sophisticated approach tries to time value these incremental taxes in the ETR upon expected future repatriation timing.

Overview of the Paper

You can imagine the various choices creates some conflicts with operating management folks around the world. ***When their access to corporate capital is as stake as well as performance measures impacting stock awards, bonuses, etc. taking on extra taxes not related to their country of operation is not a welcome thought****. It includes deferring repatriation to reduce ETR, if adjusted for time value of money is used, and also* ***motivates them to retain cash for local investments instead of competing for corporate resources****.*

Overview of the Paper

Reducing the global cash tax rate

Goal – an increase in cash tax flows increases corporate value

$$\boxed{\text{Corporate value}} = \frac{\boxed{\text{Future cash flows}}}{\boxed{\text{weighted average cost of capital}}}$$

Value drivers

Cash in

turnover growth
cash profit margins
cash tax savings
fixed assets
working capital

Cash out

WACC
cost of equity
cost of debt
capital structure
risk profile

Big Picture Questions

Use of 1 year Cash ETR

- Cash ETRs are notoriously kinky and subject to discrete events (audit payment or settlement, exercise of NQOs).
- Should some attempt be made to smooth the Cash ETR?
- Do you expect firms to plan for sustainable cash tax savings rather than one-off cash tax savings?

Big Picture Questions

Findings – domestic only sample

$1 decrease in cash tax savings

16¢ increase in current cash holdings

15¢ increase in investment

(6¢) decrease in investment

∑ 25% of $1 tax savings

75% of $1 tax savings is unaccounted for

Big Picture Questions

How are cash holdings defined?

- Cash & Cash Equivalents
- Marketable securities?

Does Apple have cash holdings of $25.9 billion or $237 billion for 2018?

Big Picture Questions

Findings –15¢ increase in investment

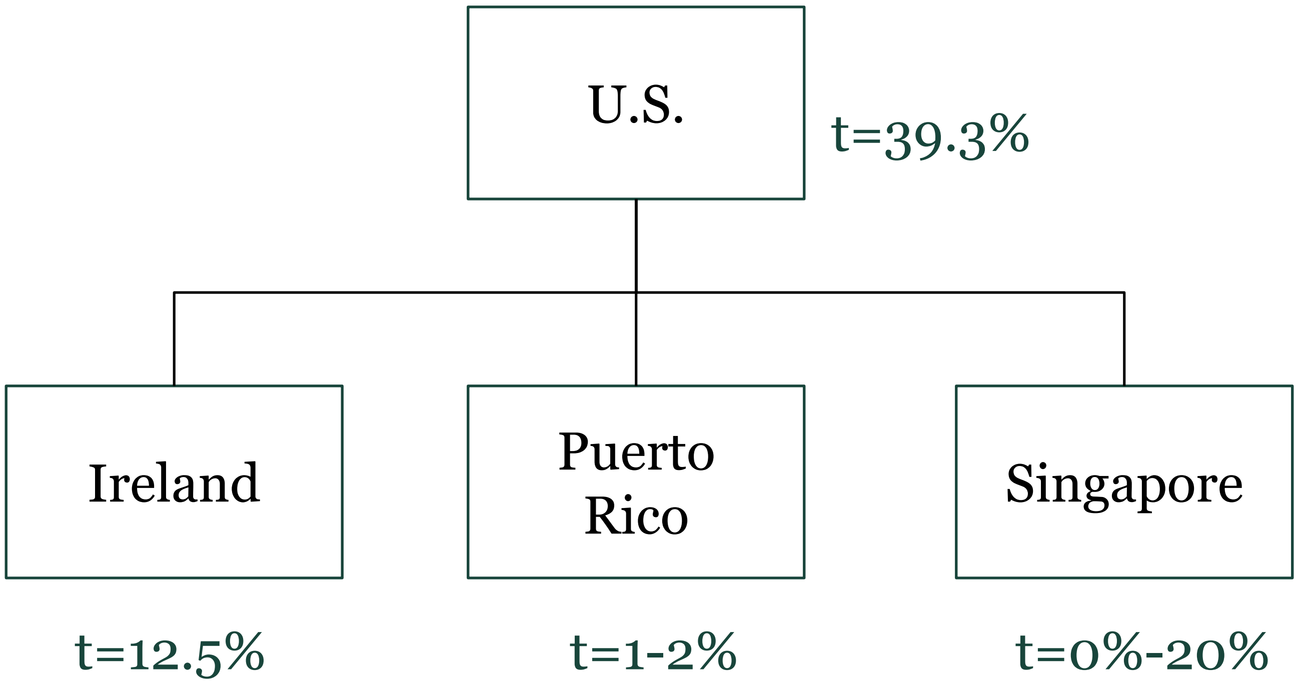
- CAPEX
- R&D and acquisitions
- Intangibles

Are the intangibles visible on the balance sheet the result of acquisitions? Self-created intangibles would not be visible.

Big Picture Questions

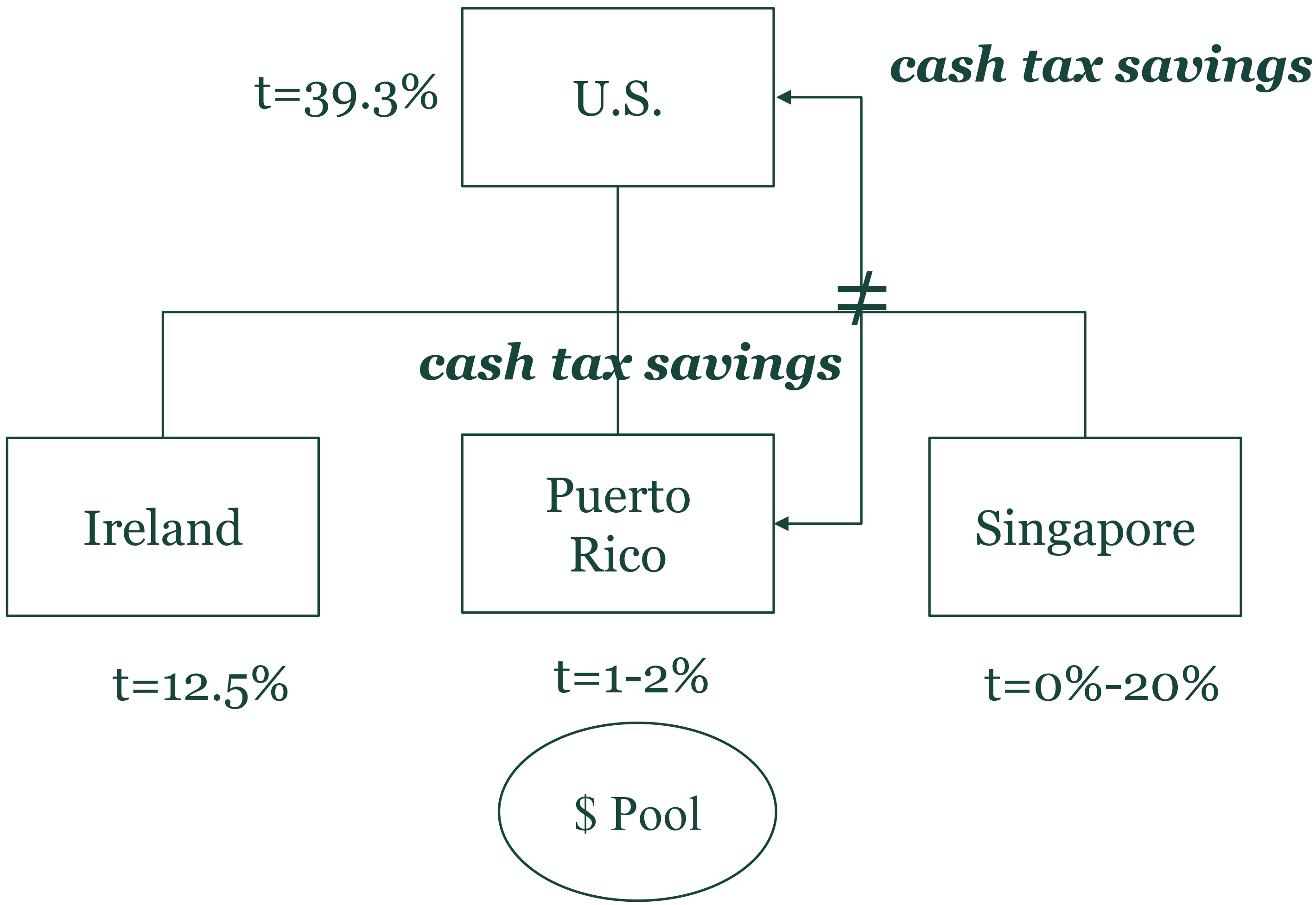
79% of your sample comprises U.S., Japan, and U.K. firms

- All three countries used a worldwide system of taxation during your sample period



Big Picture Questions

Cash tax savings conundrum



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