
Export subsidy bill to mean domestic job creation, tax holiday

On June 17th, the U.S. House of Representatives approved the American Jobs Creation Act of 2004 and repealed the FSC/ETI rules. The vote, which came in at 251-178, had stronger bipartisan support than was anticipated and included 48 Democrats. The U.S. Senate had already passed a version of the bill last month. In a round table discussion, Andrew Busch, Global FX Strategist and John McAuliffe, Manager of U.S. FX Option Sales for Harris Nesbitt discussed the situation and potential strategies.

WHAT IS DRIVING THE STRONG BIPARTISAN SUPPORT THIS BILL IS ENJOYING?

AB: Repealing the FSC/ETI subsidy to U.S. exporters was the critical driving force on the legislation after the World Trade Organization ruled these to be illegal. The ruling allowed the European Union to impose retaliatory sanctions against a variety of U.S. exports from leather to jewelry to timber to thoroughbreds. The sanctions now stand at 8% and escalate by 1% per month. In other words, just about every state is affected and therefore just about every representative/senator got a call from a constituent asking for help.

All this points to a continued focus on passing this legislation, getting it to the President to sign, and ending the sanctions.

WHAT'S THE NEXT STEP IN THE PROCESS?

AB: Although the U.S. House and Senate have each approved their own version of legislation repealing the FSC/ETI rules, and broad agreement exists between the two houses on the legislation, major differences will need to get worked out in a joint conference. First, the Senate wants the legislation to be revenue-neutral and the House version costs about \$34 billion over 11 years. Next, the House version has a \$15 billion tax cut for small business and a big tobacco buyout that is not included in the Senate's bill. Last, the Senate has a \$19 billion energy tax cut component that the House doesn't.

These provisions helped get the bipartisan support the bills needed, but they will also be the key sticking points when the conferees meet to equalize the bills. Fortunately, both versions contain language about a 12-month tax holiday, which is the critical component for corporations with offshore subsidiaries. Remember, the Republicans are touting this component as one that creates jobs for Americans and it won't be likely they will jettison it at any time from a final bill.

Businesses should be aware that obtaining favorable hedge accounting treatment may be difficult.

WHEN DO YOU ANTICIPATE THE LEGISLATION WILL BE IN PLACE?

AB: Unfortunately, Congress will only be in session for about two and half weeks between July 4th and summer recess on July 23rd. Senate Finance Committee Chairman Charles Grassley (R, Iowa) said he didn't think a conference could be completed until at least September. But there's strong pressure to get it done soon. One percent per month tariff increases ensure that the fire will get turned up every month. The job creation aspect of the legislation will also help move it forward. What better law for a President to sign when he's in a tight election than one that says, in a big banner, "Jobs Bill"?

WHAT SHOULD CLIENTS BE DOING NOW IN ANTICIPATION?

JM: Strategizing. Many of our clients are already preparing for the possibility of a tax holiday. Specifically, these clients are identifying earnings they may want to bring back if the U.S. tax holiday is approved, as these repatriation decisions are also influenced by foreign country tax rates.

TO WHAT EXTENT COULD BUSINESSES BENEFIT FROM THE BILL WHEN PASSED?

JM: The benefits of the tax holiday could see taxes on repatriation of profits cut from 35% to 5.25%. But this is enormously complicated legislation. The House's version is almost 500 pages long and the Senate's almost 1,000. The conferees really have to put their heads together to equalize both versions, and anything could happen.

WILL THE TAX CUT SURVIVE THE NEGOTIATIONS?

JM: We believe the tax cut portion will survive any conference, but there's always a risk it will not. Businesses should be aware that there's still a question as to the length of time that lawmakers will allow businesses to take advantage of a tax cut. Some estimates on the tax holiday window are as long as one year, other commentators have estimated the window will be as short as a couple of months. That timing will determine the impact on the dollar.

Businesses should also be aware that obtaining favorable hedge accounting treatment may be difficult. From an accounting perspective, it may be possible to designate an FX hedge as a balance sheet hedge or a cumulative translation adjustment (CTA) hedge, then re-designate it as an income statement hedge after the earnings dividend is declared. That way, changes in value would be reported through the income statement. All of this is subject to the client's internal auditing and accounting opinions.

There are a lot of unknowns with this bill and really, it's that way with anything political. But don't lose track of the brass ring: this is a potentially huge opportunity that needs to be analyzed and investigated due to a small time window and a potentially large tax cut.

Some clients indicated they would repatriate immediately if a tax holiday occurred so they would lock in at a lower, more favorable tax rate even if the bill is retroactively amended or repealed.

WILL CLIENTS NEED WAYS TO FUND THIS DIVIDEND PAYMENT?

JM: Yes. Many clients have foreign earnings that they have yet to repatriate and are invested in longer-dated offshore instruments. They may need to fund the repatriation by issuing debt or establishing credit facilities for their offshore subsidiaries. These clients are talking to their Harris Nesbitt/BMO representatives today to prepare for the possibility of a tax holiday. Additionally, some clients have indicated they would repatriate immediately if a tax holiday occurred so they would lock in at a lower, more favorable tax rate even if the bill is retroactively amended or repealed.

AB: From speaking with clients, I would anticipate many of them acting as soon as possible to take advantage of the tax cut. As John mentioned when it comes to politics, you never know. After the bill becomes law and if the economy starts to improve, Congress may decide to shorten the time for the tax holiday or even to eliminate it.

THIS IS CLEARLY A DIFFICULT ISSUE

J.M: It is very tricky, and there's a small risk the tax holiday could never happen. However, the reward for carefully planning for it could be large.

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") makes every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, BMO has not independently verified and makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions which may be contained herein and accepts no liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO which is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments).

Harris Nesbitt is a brand name under which Harris Nesbitt Corp., Harris Trust and Savings Bank and Bank of Montreal operate in the United States.

To U.K. residents:

The contents hereof are intended solely for the use of, and may only be issued or passed on to, persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.