Impact of the Tax Cuts and Jobs Act on International Businesses

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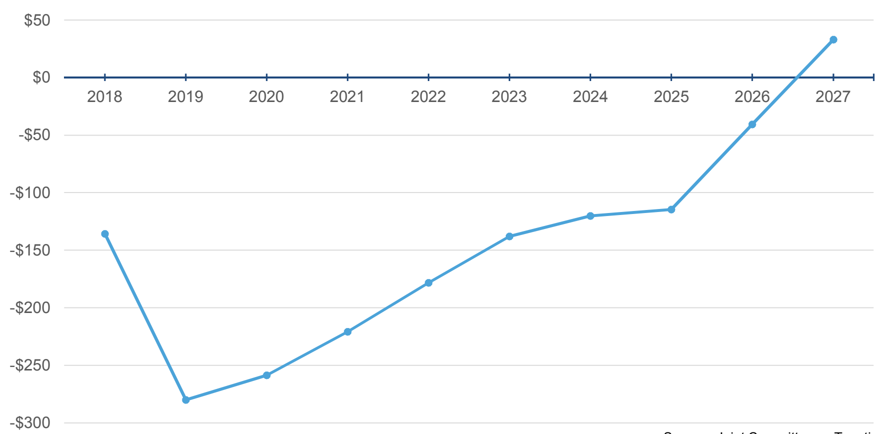
At a Glance

- Biggest set of U.S. tax reforms since 1986.
- Increases the Federal deficit by $1.5T over the next 10 years.
- Focus on making the United States competitive with the rest of the world as a place to do business while preventing certain off-shore tax planning.
  - A system of “carrots” and “sticks” to incentivize U.S. investment and operations.

Estimated Budgets Effects by Year



Source: Joint Committee on Taxation

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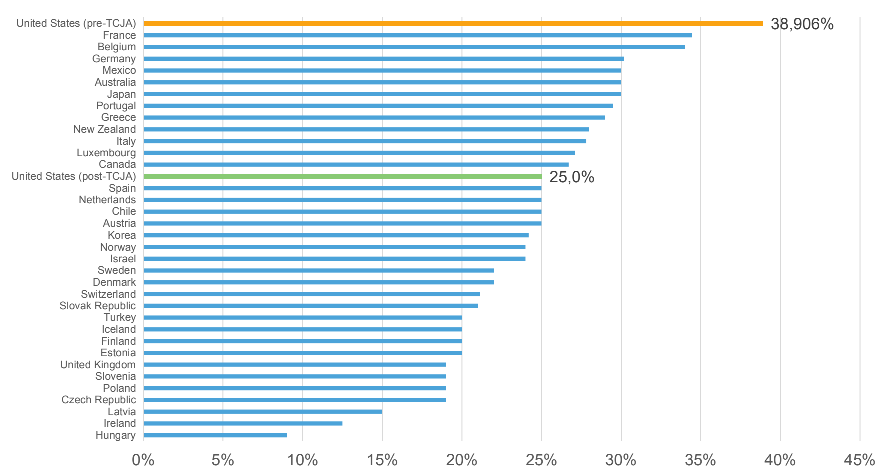
OECD Corporate Income Tax Rates



Source: OECD
Includes state/provincial tax rates

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Changes Discussed

- **Tax Rate Changes**
  - Corporations
- **Domestic Business Tax Reforms**
  - Interest Expense Deduction Limitation
  - Full Expensing
  - Net Operating Loss Limitations
  - Limitations on Business Deductions
- **International Business Tax Reforms**
  - Inbound Dividends
  - Global Intangible Low-Taxed Income ("GILTI")
  - Base Erosion and Anti-Abuse Tax ("BEAT")
  - Foreign-Derived Intangible Income ("FDII")
  - Inbound/Outbound Transfers
  - Foreign Investments in U.S. Property
  - Related Party Payments

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Tax Rate Changes

Tax Rates – Corporations

New Law:

- The statutory corporate income tax rate is reduced from 35% to 21%.

Observations:

- Assuming a blended combined Federal/State rate of ~25%, the United States goes from having one of the highest rates to a more or less average rate of tax amongst OECD Member States.
- But the United States taxes worldwide income (still) in many ways that other OECD Member States do not.
- Even with a corporate rate of 21%, it's still (usually) cheaper for an individual to operate a business directly or through a flow-through entity.

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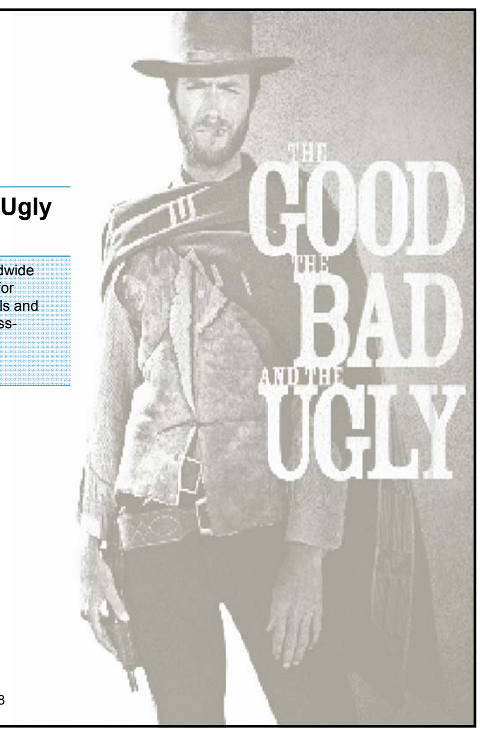
	The Good	The Bad	The Ugly
Corporate Rates	Blended Federal/State rate of ~25%	U.S. really has a higher rate due to unique anti-deferral regimes for offshore income	Still worldwide taxation for individuals and some pass-throughs



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Domestic Business Tax Reforms

Interest Expense Deduction Limitation

New Law:

- A taxpayer's ability to deduct interest expense is limited to 30% of adjusted taxable income.
- Adjusted taxable income is an "EBITDA" proxy (calculated under tax principles), but becomes an "EBIT" proxy starting in 2022.

Observations:

- The limitation is generally in line with the rules recommended by the OECD.
- No grandfathering for existing debt.
- Indefinite carryforwards
- The transition to EBIT is painful and appears unsupported by policy or analogous guidelines.
- Special exceptions for real property businesses, public utilities and car dealerships.
- Disincentivizes leveraged transactions, increases the attractiveness of equity funding (including preferred equity).

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Full Expensing

New Law:

- Acquisitions of tangible personal property (not land or intangible property) can be fully expensed in the year of acquisition.
- The full expensing begins to phase out by 20% each year starting in 2023.

Observations:

- Uses the existing 50% bonus depreciation regime and increases it to 100% while also expanding eligible property to include used property.
- Can be great for asset deals or stock deals for which a § 338 election is made.
- Does not apply for purposes of GILTI and FDII (discussed later).
- Be careful—expensing yourself into an NOL position is not nearly as valuable. Electing out is permitted on a class-by-class, year-by-year basis.

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Net Operating Loss Limitations

New Law:

- Net operating losses ("NOLs") can never be used against more than 80% of taxable income in any given year.
- NOL carrybacks are eliminated and NOLs can carry forward indefinitely.

Observations:

- With a decreased tax rate and increased limitation on use, NOLs have lost significant value.
- Imports and amplifies an AMT concept.

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Domestic Business Tax Reform

	Winners	Losers
Interest Expense Limitation	Real estate and special industries (car dealerships, utilities)	Private equity, inverted companies
Full Expensing	Capital intensive businesses, M&A purchasers	Companies expecting current-year losses, real estate and utilities
NOL Loss Limitations	None	Loss companies

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International Business Tax Reforms

Inbound Dividends

New Law:

- A U.S. corporation is not taxed on dividends received from most foreign corporations in which they own at least 10% of the stock.
- No foreign tax credits allowed for tax-free dividends under this rule.
- Not available for dividends that are deductible at the level of the payor.

Observations:

- U.S. corporate shareholders win, individual shareholders lose -- but why?
- Upstream, inbound loans may still be needed in many cases due to immediate cash needs, solvency requirements, blocked cash (see below on investments in U.S. property).
- Beware of hybrid dividends.
- Practical effect may be tempered by disallowance of foreign tax credits and local law impediments to a foreign corporation making a dividend.

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Inbound Dividends – Transition Tax

New Law:

- A one-time tax on accumulated foreign earnings of foreign subsidiaries.
- The tax rate is 15.5% to the extent of non-U.S. cash (and similar assets) and 8% otherwise.
- By election, the tax is payable in 8 annual installments.

Observations:

- Cash now, tax later. Will financing be required?
- The tax may have an immediate financial statement and near-term cash tax effect.
- Consider the effects of additional liabilities on debt covenants.
- Calculation of the tax is complicated and likely will not reflect the group's current true cash position.
- An 8-year tax liability tail affects M&A—valuation, diligence, and drafting.
- Fiscal year taxpayers get more time to calculate the tax.

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Global Intangible Low-Taxed Income (“GILTI”)

New Law:

All income of controlled foreign corporations (“CFCs”) is subject to a minimum tax in their U.S. shareholders’ hands, except to the extent that it represents a fixed routine return on tangible assets.

- The rate is 10.5% for U.S. corporations, against which 80% of foreign tax credits can be used.
- Conceptually, little tax may be due if the CFC is taxed in its jurisdiction at a rate of at least 13.125%.

Observations:

- Hits U.S. multinationals with low-taxed foreign subsidiaries. Aimed at companies like Apple that have been paying little in overseas taxes.
- May reduce the use of “tax haven” jurisdictions, but there are still significant benefits to low foreign tax rates.
- Under the new laws, more foreign subsidiaries will be CFCs (and thus become subject to GILTI)

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Base Erosion and Anti-Abuse Tax (“BEAT”)

New Law:

- The BEAT is a new 10% minimum tax that generally applies to U.S. corporate members of large multinational groups making deductible payments to or property acquisitions (other than inventory) from non-U.S. affiliates.
- Very generally, the BEAT acts like a partial denial of deductions for U.S. corporations making outbound related-party payments.

Observations:

- Exclusion of payments to purchase inventory (COGS) is a dodged bullet for U.S. importers
- Two of the biggest losers are inverted companies and non-U.S. financial institutions receiving payments from their U.S. affiliates.
- European finance ministers have criticized the BEAT—it’s not clear if the tax will be challenged under WTO rules or violates U.S. tax treaties.
- Unintended consequences? What routine supply chains and cash flows will be disrupted?

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Foreign-Derived Intangible Income ("FDII")

New Law:

- U.S. corporations are taxed at a 13.125% rate to the extent that their income (above a fixed routine return on tangible property) is derived from foreign sales or services.

Observations:

- May be an impermissible export subsidy under WTO rules.
- Does FDII affect the choice for a U.S. company to operate in a foreign country as a CFC or as a branch?
  - CFCs get taxed under GILTI, but at a lower rate, and possibility for some deferral.
  - Foreign branches get taxed under regular U.S. rates (no FDII benefit). Limited ability to credit foreign taxes against U.S. income tax.
  - Sales to the foreign country from the U.S. would be taxed as FDII, but credits generally may be partially or completely denied for any foreign taxes paid.

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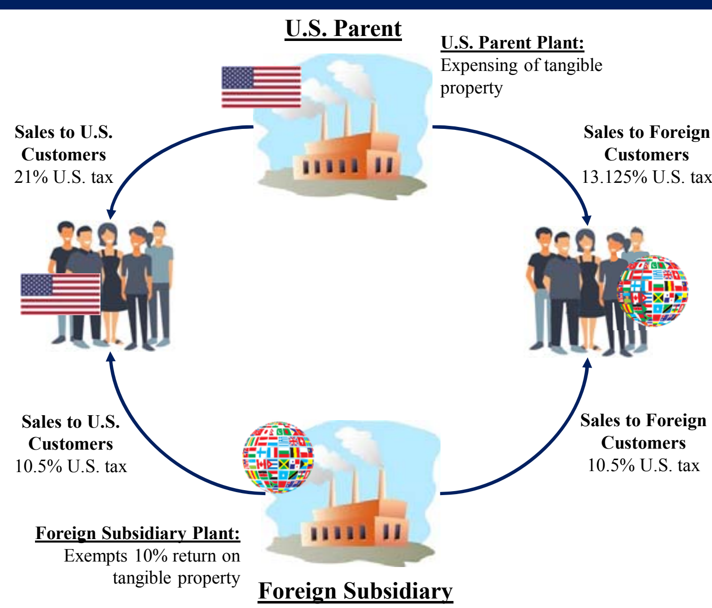
Changing Incentives? Or the Same?



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Inbound/Outbound Transfers

- The changes to international taxation are not necessarily sufficient to incentivize repatriation of off-shore IP and other assets/operations.
  - What if the law is repealed (perhaps unlikely)? What if the U.S. corporate rate increases (likely)?
  - A 13.125% rate is generally available off-shore as many jurisdictions offer attractive rates of 13.125% or lower, depending on appetite for tax havens.
  - Once the IP is back in the U.S., it's costly and difficult to send it back off-shore due to other changes brought by tax reform.
  - The FDII provision may be determined to be impermissible by the WTO, although such a determination would likely be several years in the future.
  - Many countries impose exit taxes on outbound transfers of IP.

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Foreign Investments in U.S. Property

New Law:

- CFC guarantees of U.S. shareholder debt and loans to U.S. shareholders can continue to produce "phantom" taxable income to U.S. shareholders.
- Actual distributions of a CFC's earnings to its U.S. corporate parent would be tax-free.

Observations:

- Has I.R.C. Section 956 been declawed?
- Will the market standard change for limitations on pledges and guarantees by CFCs in debt documents?
- With one-time repatriation tax and new GILTI tax, there will be a lot of previously-taxed income that can shelter investments in U.S. property, but certain companies may not have enough previously-taxed income.

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Related Party Payments

New Law:

- Payments of related-party royalties or interest on hybrid transactions or to hybrid entities are non-deductible to the extent not taxed in the recipient's jurisdiction.
- Hybrid transaction – Payment that is treated as royalties or interest for U.S. tax purposes but not for local tax law purposes in the recipient's jurisdiction.
- Hybrid entity – Entity that is flow-through for U.S. purposes and regarded in its local jurisdiction, or vice versa.

Observations:

- In the United States, a transfer of less than "all substantial rights" to IP is a license, but it may be treated as a sale under foreign law -- some or all of the royalty deduction can be denied.
- Carefully examine hybrid instruments (e.g., CPECs) in your structure, as well as hybrid entities (e.g., Dutch CVs) to avoid unintended loss of deductions.

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WHAT'S NEXT?

- The new laws raise many questions left to the Treasury Department to answer through regulations.
- The U.S.' trading partners are concerned that key parts of the legislation are illegal under the rules of the WTO, and have threatened to file suit.
- Technical corrections bills may be unlikely to pass because they need 60 votes in the Senate.
- Could all these changes be undone after the next Presidential election? Could we at least see a corporate tax rate increase?

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