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.

  o A system of “carrots” and “sticks” to incentivize U.S. investment and operations.
Estimated Budgets Effects by Year

Source: Joint Committee on Taxation

OECD Corporate Income Tax Rates

Source: OECD
Includes state/provincial tax rates
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**
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.

<table>
<thead>
<tr>
<th>The Good</th>
<th>The Bad</th>
<th>The Ugly</th>
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<tbody>
<tr>
<td>Corporate Rates</td>
<td>Blended Federal/State rate of ~25%</td>
<td>U.S. really has a higher rate due to unique anti-deferral regimes for offshore income</td>
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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).
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.

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.
## Domestic Business Tax Reform

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

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.
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)

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?
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.

Changing Incentives? Or the Same?

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<th>U.S. Parent Plant: Exemption of tangible property</th>
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<td>Sales to U.S. Customers</td>
<td>21% U.S. tax</td>
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<td>Sales to Foreign Customers</td>
<td>13.125% U.S. tax</td>
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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.
  
  o What if the law is repealed (perhaps unlikely)? What if the U.S. corporate rate increases (likely)?
  
  o 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.
  
  o 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.
  
  o The FDII provision may be determined to be impermissible by the WTO, although such a determination would likely be several years in the future.
  
  o Many countries impose exit taxes on outbound transfers of IP.

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.
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.

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?