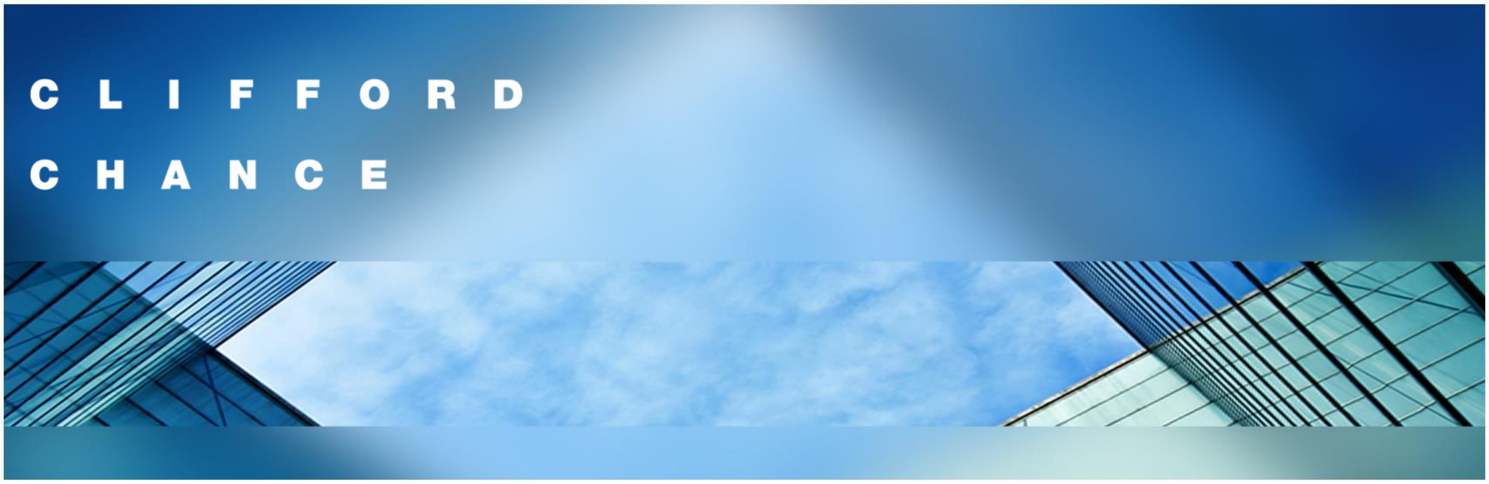

US TAX REFORM: WHO COMES OUT AHEAD?

On December 20, 2017, Congress voted to enact the most sweeping US tax reform bill in decades. The Tax Cuts and Jobs Act (the "TCJA" or the "Act") will reduce business tax rates and revamp the US international tax system. While the President may not sign the Act until January 2018, its adoption into law appears virtually certain.

OVERVIEW

The TCJA's proponents in Congress intend it to boost US businesses by making a host of changes to how they are taxed. While the legislation has (somewhat unexpectedly) passed through Congress at warp speed, many of its basic ideas have been advanced in some form by the Act's Republican authors for over a decade. Key provisions of the Act include, as described in more detail below, a permanent reduction in the US federal corporate income tax rate from 35% to 21%; reduced tax rates (ranging up to 29.6%) for many US businesses organized as partnerships, limited liability companies (LLCs) and S corporations; immediate expensing of the full cost of equipment bought before 2023; and broad changes to the United States' international tax rules, including tax-free repatriation of profits earned abroad in the future.

The TCJA may well spur US M&A activity, by raising after-tax rates of return on investment in US companies. However, the new law's impact on even routine corporate transactions can vary dramatically - for better or for worse - depending on precisely how those transactions are structured. The Act also has a disparate impact on differently situated businesses. In effect, the Act's authors give:

- three cheers for US companies with significant US operations, who benefit from rate reductions and accelerated expensing;
- two cheers for US multinationals, who get a territorial system (subject to some key limits) and who also will now repatriate hundreds of billions of dollars of earnings accumulated offshore, at reduced tax rates up to 15.5%; and
- one cheer for non-US multinationals with material US operations, who face new anti-avoidance rules aimed at limiting historically accepted means of repatriating profits from the United States without material US tax costs.

THREE CHEERS FOR US COMPANIES WITH SIGNIFICANT US OPERATIONS

The TCJA provides its biggest benefits to US companies investing in US businesses.

- Reduced Corporate Income Tax Rate. The TCJA reduces the top US federal income tax for US corporations from 35% to 21%. That is the lowest corporate rate in the United States in almost 80 years. The rate is significantly lower than the current corporate tax rates in a number of other major economies (China, 25%; France, 33%; Germany, 30%; Japan, 31%; Spain, 25%), and not much higher than the rates in several others (e.g. the UK, 19%). While many of the cuts in individual tax rates in the Act are temporary, this cut to the corporate rate is not scheduled to expire.
- Deduction for Earnings From "Passthrough" Entities. Many closely held US businesses take the form of LLCs, partnerships and S corporations. Although privately held, such companies in many cases are as large as, or larger than, US publicly traded companies. A "pass-through" entity like the ones just described, normally is not subject to US federal corporate income taxes – instead its owners, often US individuals, are taxed on the entity's profits. Historically, US individuals have paid tax on such profits at normal individual rates (up to 39.6%). However, the Act provides such individuals with a deduction, which has the effect of reducing their top rate of tax to 29.6% on the profits of many pass-through entities.
  - More specifically, the deduction is available for income generated by business operations of such an entity that are located in the United States.
  - The deduction is limited if the payroll of such US operations falls below a specified level; and the deduction generally is not available at all for entities engaged in some types of services businesses (including certain financial and investment management services, consulting, accounting, and law).
  - Such deduction will also result in an individual generally being subject to tax on ordinary dividend income from a real estate investment trust (REIT) at the 29.6% effective tax rate.
- 100% Expensing of the Cost of Newly Acquired Equipment. The Act allows for most tangible property (other than real estate) acquired after September 27, 2017 and before January 1, 2023 to be fully expensed during the first tax year in which it is used in a trade or business. Tangible property acquired during tax years beginning in 2023 will be 80% deductible in that tax year, scaling down 20% each year, with no special expensing available for 2027 and subsequent years. The new provision applies to both new and used assets, provided that it is the taxpayer's first use of its acquired assets in its trade or business. This rule will increase the attractiveness of structuring acquisitions of plant- or equipment-intensive businesses as asset purchases (rather than share purchases).
- 30% Limit on Interest Deductions. The TCJA generally limits interest deductions to the sum of a US company's business interest income for the

taxable year, plus 30% of the company's "adjusted taxable income" for the year.

- Adjusted taxable income: For taxable years beginning before January 1, 2022, adjusted taxable income is computed as net income without regard to interest income or expense, depreciation, and amortization, (i.e., using "EBITDA"). Thereafter, adjusted net income is computed taking into account depreciation and amortization (i.e., using "EBIT").
- Carryforward of disallowed interest expense: Disallowed interest deductions will be treated as business interest paid or accrued during the succeeding taxable year, and there is no limit on how many years interest deductions disallowed under this rule may be carried forward.
- No grandfather rules: There is no grandfathering for debt issued prior to enactment of the TCJA.
- Real estate exception: A taxpayer conducting a real property trade or business (e.g., a development, construction, rental, management or leasing business) can elect out of the 30% limit; but if it does so, it must claim depreciation deductions for its real property over longer periods than otherwise would be available.

Although this new rule limits the tax deductions available from using debt financing (particularly after 2021), the impact of the limitation is somewhat blunted, since the deductions are less valuable due to the Act's rate reductions.

TWO CHEERS FOR US COMPANIES INVESTING ABROAD

Prior to the Act, the United States' tax laws did not give a US parent company of a multinational group the benefit of a "territorial system," under which profits of non-US subsidiaries earned overseas would be exempted from US tax when those profits were repatriated back to the United States. Instead, contrary to the approach adopted by other major world economies, the United States taxed such profits at regular US corporate rates when they were repatriated back to the US parent, with a credit for any taxes paid overseas on those profits by the corporate group. The Act seeks to switch to a territorial system; but it contains limits designed to ensure that most or all of a US-headed multinational group's income is taxed at least once, somewhere in the world.

- Exemption for Dividends from Non-US Affiliates. Under the Act, a US corporation is generally entitled to deduct the full amount any dividend paid to it by a non-US company at least 10% of whose shares are owned by the US corporation. The effect of the deduction is that such dividends are exempt from US corporate income tax.
  - Exemption applies to JVs: As noted, this benefit is available not only for dividends from a US corporation's wholly-owned or majority-owned non-US subsidiaries, but also for dividends from any non-US JV in which the US corporation has (at least a 10%) minority interest.
  - Limits on exemption: The exemption is available only to a US corporation that holds its interest in the non-US company for over a year. Dividends received during the first year of a US corporation's holding period are

eligible for the exemption, as long as the US corporation ends up holding the shares of the non-US company for over a year. In addition, the exemption is generally not available for a dividend paid on a hybrid instrument (treated as equity for US tax purposes, but treated as debt, or as some other instrument that generates deductible payments for the non-US company, for non-US tax purposes).

- Gain on sales of shares: The Act does not provide a specific exemption for a US corporation's gain from a sale of shares in a 10%-owned non-US company. But, it often may be possible for a US corporation to get the effect of a partial or full exemption.
  - Under the US tax laws, a US corporation generally must re-characterize a portion of its gain from a sale of shares of a 10%-owned non-US company as a dividend, if over 50% of the shares of that non-US company are owned by large US shareholders (each with a stake of 10% or more). In such a case, the portion of the seller's gain treated as a dividend equals the seller's pro rata share of any retained earnings of the non-US company whose shares are being sold. Thus, for example, if a US parent sells shares of a non-US subsidiary that has significant retained earnings, then a large part of the US parent's gain on the sale would be re-characterized as a dividend – and, as a result, would be exempt from US tax, under the new rules.
  - If a non-US company sells a business in an asset sale (or a transaction structured to be treated as an asset sale for US tax purposes), and the non-US company then distributes the sale proceeds to its US parent, then the US parent generally would get an exemption from US tax for all of the sale proceeds it receives. (This US tax advantage would need to be balanced, however, against any increase in non-US tax costs that might arise as a result of structuring the transaction in this manner.)

- Mandatory Repatriation. Without a forced repatriation rule, Congress' adoption of a territorial system would allow non-US subsidiaries to pay dividends to their US parent corporations, out of (hundreds of billions of dollars of) earnings built up offshore before 2018, and fully escape US tax on those earnings. Congress instead opted to impose a one-time US tax on those earnings, at rates far lower than a US parent would have paid before the Act.
  - Under the Act, a 10% (or greater) US shareholder must include in its income, in 2017, its share of a non-US company's earnings that have not previously been subject to US tax. This rule applies to all 10% US shareholders (including US individuals and US pass-through entities), even though only a 10% US corporate shareholder will benefit from the new territorial system.
  - To the extent a non-US corporation has invested its accumulated earnings in cash or cash equivalents, a 10% US shareholder will be taxed at a 15.5% rate on those earnings. A 10% U.S. shareholder will be taxed at an 8% rate on earnings that have been reinvested in the corporation's business (such as in non-U.S. property, plants and equipment).

  - Although a 10% US shareholder's tax liability will be triggered when it includes the offshore earnings in its income in 2017, the US shareholder is entitled to elect to pay off this tax liability in installments over eight years, as follows: 8% in each of the first five years after 2017 (2018 – 2022); 15% in the sixth year (2023); 20% in the seventh year (2024); and 25% in the eighth year (2025).

- Low-Taxed Intangibles Income. Under the Act, a US parent corporation generally will have to pay an immediate US income tax (at a 10.5% rate, increasing to 13.1% after 2025) on a big part of the profits of its non-US subsidiaries, in the year those profits are earned regardless of whether or when the profits are repatriated to the United States, unless the non-US subsidiaries (in the aggregate) pay a material amount of non-US income taxes on their profits.
  - This special regime applies to "global intangible low-taxed income" (GILTI) earned by a US parent's non-US subsidiaries. Broadly, GILTI is defined as the non-US subsidiaries' earnings, reduced by a formulaic amount representing the part of those earnings attributable to the non-US subsidiaries’ tangible depreciable assets (e.g., machinery and equipment).
  - From 2018 through 2025, the US parent must pay US income tax on its pro rata share of the non-US subsidiaries' GILTI at a 10.5% rate. In 2026 and thereafter, the rate rises to 13.1%.
  - A US parent is entitled to a credit against this US income tax, for 80% of the total amount of non-US income taxes that it and its subsidiaries pay on their GILTI. The practical effect is that, from 2018 through 2025, a US parent will pay no US income tax on its GILTI, provided the effective rate of non-US tax imposed on such income is at least 13.1%. (10.5% = 80% x 13.1%.) If the non-U.S. effective tax rate is less than 13.1%, then the US parent's corporate group will pay a combination of US and non-US income taxes on the group's GILTI, at combined effective rates ranging from 10.5% to 13.1%. (Similarly, in 2026 and thereafter, the US parent will pay no US tax on its GILTI, provided the effective rate of non-US tax on the GILTI is 16.4%. Otherwise, the US parent's corporate group will pay a combination of US and non-US income taxes on the group's GILTI, at combined effective rates ranging from 13.1% to 16.4%.)
  - The GILTI rules apply not only where a US corporation is the parent of non-US subsidiaries, but also where a US pass-through entity is the parent (or where a US individual owns a non-US company). However, the impact of the rules on a pass-through entity and US individuals owning it (or on an individual that directly owns a non-US company) often will be more severe, than in the case of a US corporate parent. This is in part because such US individuals normally will not be entitled to the 80% tax credit described above.

- Export Incentive. The TCJA provides a rate benefit for a US corporation's income derived from serving non-US markets. The benefit applies to "foreign derived intangibles income" (FDII), which is broadly defined as all of a US corporation's income generated from property sold, leased or licensed by a US corporation to any person that is not a US person, reduced by a formulaic return on the tangible assets used in generating such income. A US corporation will be taxed at a 13.1% rate on its FDII, in 2018 through 2025; thereafter, the rate increases to 16.4%. This provision, together with the GILTI rules, seemingly is meant to incentivize US multinationals to locate in the United States more of their assets and operations that are used in serving overseas markets. However, it is unclear how strong this incentive will prove to be: sales to overseas customers made by a non-US subsidiary of a US parent generally are subject to US tax under GILTI at a 10.5% rate (13.1% after 2025) – i.e., 2.6 percentage points lower than the rate imposed on the US parent's FDII. Also, it has yet to be determined whether the FDII rules comply with international trade agreements.

On balance, the new territorial system makes it attractive for a US company to buy or invest in non-US subsidiaries and JVs. However, acquisition and investment opportunities where profits will be subject to low or no non-US income taxes may turn out to be more costly than anticipated, absent structuring to address the new "GILTI" rules.

ONE CHEER FOR NON-US COMPANIES INVESTING IN THE UNITED STATES

The TCJA includes a number of provisions that will increase the burdens on non-US headed multinational corporate groups investing in the United States.

- Base Erosion and Anti-Abuse Tax. If a multinational corporate group has large US operations, then the US companies in the group generally are subject to a 10% minimum tax on the amount of any "base erosion tax benefits" they derive from transactions with non-US affiliates. (The applicable rate is 5%, rather than 10% for 2018, and rises to 12.5% after 2025.)
  - Scope of the rules: The rules only apply to corporate groups whose US operations generate average annual gross receipts of more than $500 million. In addition, the US companies in such a group must have "base erosion tax benefits" that account for 3% or more of the total deductions claimed by those US companies.
  - Base erosion tax benefit: Generally, a base erosion tax benefit is any deduction resulting from a payment by a US company to a "related party" (e.g., interest, royalties, services fees), as well as depreciation or amortization arising from an asset purchased from a related party. Certain exceptions apply to payments (and related deductions) under derivative contracts and for services generally considered to be routine.
  - Related party: For these purposes, a "related party" generally includes a 25% owner of the applicable US company; a person that has over 50% common ownership with the US company, or with a 25% owner of the US company; or any other person that, under the facts and circumstances, is under common control with the US company. Certain constructive ownership rules apply, when determining whether a person is a 25% owner and whether there is over 50% common ownership.
  - Treaty override: The new 10% tax appears to be intended to override any contrary provisions of existing US tax treaties.

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- This rule is widely enough drafted to reach many common transactions. For example, if a non-US parent borrows from banks or in the capital markets, and then on-lends part or all of the proceeds to a US subsidiary, interest on the intercompany loan would result in a "base erosion tax benefit."
- Special rules apply to banks and securities dealers.

- Anti-Hybrid Rule. Under the Act, a US company no longer is allowed a deduction for an interest or royalty payment to a non-US affiliate that has over 50% common ownership with the US company, where the payment is not included in the income of the non-US affiliate under the tax laws of its country of residence, or the affiliate is allowed a deduction offsetting that income under such tax laws. This new rule, for example, appears to eliminate the benefits from cross-border intragroup financing transactions structured to be treated as a repo for non-US tax purposes, but as debt for US tax purposes.
- Broader CFC Rules. The TCJA significantly expands the scope of the United States' controlled foreign corporation (CFC) rules, where a non-US parent owns both US and non-US subsidiaries. In such a case, non-US subsidiaries which are sister companies to the US subsidiaries, are now treated as CFCs. Unlike most provisions in the Act, this one will be effective starting in **2017**.
  - One result is that, at a minimum, the US subsidiaries will generally need to make detailed annual filings with the IRS regarding the activities of the non-US subsidiaries, starting with the US tax returns the US subsidiaries file for 2017.
  - In addition, in such a case, if a US subsidiary owns (directly or through subsidiaries) 10% or more of the shares of a non-US sister company, then the US subsidiary generally must include in income its pro rata share of passive-type income (dividends, interest, royalties) and certain other income received by the non-US sister company.
  - Also, while Congress' official commentary on the Act implies that Congress intended otherwise, a literal reading of the Act indicates that if a minority US shareholder owns 10% or more of a non-US parent company, which in turn has at least one US subsidiary (large or small), then the minority US shareholder may be subject to the CFC rules with respect to all of the non-US subsidiaries owned by such non-US parent company. The US shareholder in that case would have to pay US tax on its pro rata share of any income of the relevant types that is received by any of those non-US subsidiaries, and the US shareholder also generally would need to make detailed filings with the IRS about those subsidiaries.
- Anti-Inversion Rules Are Here to Stay. The TCJA did not do away with any of the anti-inversion rules that had previously been adopted by Congress and the Obama administration, which broadly address cases where parties to a cross-border M&A deal seek to obtain US tax benefits by having a (smaller) non-US company acquire a (bigger) US merger partner, in a share for share transaction. In fact, the Act imposes extra restrictions meant to make inversions less attractive. The basic approach reflected in the new law is to try to give incentives for US companies to remain in the United States, and to continue to penalize them if they attempt to exit by way of inversions.

WHAT NOW?

- House Ways and Means Committee Chairman Kevin Brady, R-Texas, said that "a lot of good provisions got left on the cutting room floor" so that the TCJA could be passed quickly. Congressman Brady recommends that Congressional Republicans "assess each of [those provisions] to decide what the path forward is," and expects more tax law changes in future budgets. Brady added, "Plus, I think we'll have to continue to modify the international code over time."
- This legislation passed without any votes from the Democratic Party. It is possible that the Democrats, should they regain control of Congress, may seek to significantly alter the TCJA. That being said, prior experience indicates it may be difficult to undo rate cuts and other benefits that prove to be popular with US businesses. In addition, the portions of the Act that overhaul the international tax rules, have a number of key elements in common with proposals made by Democrats during the Obama administration.
- On balance, many companies may seek to avail themselves in the near term of some of the time-limited advantages created by the Act, including by making US acquisitions (particularly purchases of US plant and equipment). Companies also will need to take a close look at their current and expected future debt financing in the United States; they will want, to the extent possible, to set the terms of US debt in a manner that allows them to optimize interest deductions in light of the 30% limit.
- "Pass-through" entities will need to address a number of complexities, including how to structure compensation and equity ownership arrangements for US individuals working in these entities' businesses, and how to structure their international operations.
- Non-US headed groups will need to immediately contend with the change in the CFC rules described above, as well as the various new restrictions on intercompany debt financing and IP arrangements.
- Over the longer term, both US-parented and non-US parented multinational groups face a more complicated picture. The Act together with BEPS and other multinational initiatives may continue to gradually push such groups away from use of tax havens, in favor of corporate structures that focus on maximizing lightly taxed income in countries where the group has real operations….which might turn out, in some cases, to be the United States.

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