What does US tax reform mean for foreign-owned companies?

Presenters: Rob Alinsky, Josh Johnson, Steven Arluna
Agenda

• Tax reform impact and overview
• Corporate changes
• Limitation on interest expense
• Pass-through entities
• State tax considerations
• Anti-hybrid provisions
• Base erosion and anti abuse tax (BEAT) provisions
• Foreign derived intangible income deduction (FDII) provisions
• Overview of rules impacting foreign subsidiaries of U.S. companies
• Stock attribution rules
• Tax planning opportunities
Headlines

• Maximum individual tax rate dropped to 37 percent
• Corporate tax rate reduced from 35 percent to 21 percent
• Income from flow-through entities (partnership and S corporations) eligible for a 20 percent deduction
  − Effective tax rate on flow-through income of 29.6 percent, plus 3.8 percent net investment income tax
  − Compare to corporate tax rate of 21 percent
• Other business changes including relating to interest, expensing, and carried interests
Corporate changes
## Corporate changes

<table>
<thead>
<tr>
<th>Tax change</th>
<th>Post reform law</th>
<th>Considerations</th>
</tr>
</thead>
</table>
| Reduced corporate tax rate and move to territorial type system | • Reduced **21 percent** flat corporate federal income tax rate from **35 percent**, generally effective Jan. 1, 2018  
• **Territorial** type system allows more tax efficient repatriation | • Companies need to consider whether flow-through or corporate structure is most efficient  
• Investor make up?  
• How significant are foreign earnings? |
| Immediate expensing – bonus depreciation | • 100 percent bonus depreciation through 2022, then phased out through 2026  
• Applies to new and used property acquired and retroactive to assets placed in service after Sept. 27, 2017 | • Adds more importance to purchase price allocation agreements  
• Asset deals are even more attractive  
• States may not conform |
### Corporate changes (cont.)

<table>
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</table>
| Net operating loss (NOL) rules    | • Limits NOL deduction to **80 percent** of taxable income for NOLs arising in years beginning after Dec. 31, 2017  
• Eliminates NOL **carrybacks** for NOLs arising in years ending after Dec. 31, 2017  
• NOLs generally carried forward **indefinitely** if they arise in years ending after Dec. 31, 2017 | • Immediate expensing benefit is reduced to the extent it generates an NOL  
• Fiscal year taxpayers with years ending after Dec. 31, 2017 cannot carryback losses  
• Limited impact on state NOLs as many states have their own NOL deduction provisions |
| Corporate alternative minimum tax (AMT) & AMT credit | • **Repeals** corporate AMT for tax years beginning after Dec. 31, 2017  
• Credits can be refundable | • Refundable credit is an unexpected benefit |
# Interest deduction limitations

<table>
<thead>
<tr>
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| New interest deduction limitation | • Limits the net interest expense deduction to 30 percent of adjusted taxable income (ATI)  
• For 2018 through 2021, ATI will approximate earnings before interest, taxes, depreciation and amortization (EBITDA)  
• After 2021, ATI will approximate earnings before interest and taxes (EBIT)  
• Disallowed interest generally may be carried forward indefinitely  |
|                                   | • Limitation does not apply to businesses with an average gross receipts of ≤$25 million and certain agricultural, farming and real estate businesses  
• **Net interest expense** so back to back loans remain viable for intercompany financing activities  
• Real property trade or businesses that use alternative depreciation system (ADS) and farming businesses may elect not to be subject to the business interest deduction limitation |
Interest deduction limitations (cont.)

<table>
<thead>
<tr>
<th>Tax change</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>New interest deduction limitation</td>
<td>• Leveraged acquisitions get hit hard under this provision</td>
</tr>
<tr>
<td></td>
<td>• Analyze opportunities to move debt around the worldwide group to best utilize interest deductions</td>
</tr>
<tr>
<td></td>
<td>• Project and calculate deduction limitation effects</td>
</tr>
<tr>
<td></td>
<td>• Could have significant effect on cost of capital</td>
</tr>
<tr>
<td></td>
<td>• Possibilities may exist to replace debt with rental, royalty, swap, partnership guaranteed payment arrangements or equity such as preferred stock</td>
</tr>
<tr>
<td></td>
<td>• Leveraged blockers and gross receipts and flow-through investments lack clarity</td>
</tr>
<tr>
<td></td>
<td>• Expect significant regulatory guidance</td>
</tr>
</tbody>
</table>
### Interest deductions: Example

<table>
<thead>
<tr>
<th>Example of net interest deduction limitation</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>2.00</td>
<td>2.50</td>
<td>3.00</td>
<td>4.00</td>
<td>5.00</td>
<td>6.00</td>
</tr>
<tr>
<td>Addback: Interest expense</td>
<td>3.00</td>
<td>3.00</td>
<td>3.00</td>
<td>3.00</td>
<td>2.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Addback: Depreciation &amp; amortization</td>
<td>2.00</td>
<td>2.00</td>
<td>2.00</td>
<td>2.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Adjustable taxable income (EBITDA or EBIT for 2022)</strong></td>
<td>7.00</td>
<td>7.50</td>
<td>8.00</td>
<td>9.00</td>
<td>7.00</td>
<td>7.00</td>
</tr>
<tr>
<td>Multiply by 30% of adjustable taxable income</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
</tr>
<tr>
<td><strong>Net interest deduction</strong></td>
<td>2.10</td>
<td>2.25</td>
<td>2.40</td>
<td>2.70</td>
<td>2.10</td>
<td>2.10</td>
</tr>
</tbody>
</table>

| Taxable income (before interest expense)    | 5.00 | 5.50 | 6.00 | 7.00 | 7.00 | 7.00 |
| Net interest deduction                      | (2.10)| (2.25)| (2.40)| (2.70)| (2.10)| (2.10)|

| Estimated taxable income/(loss) before NOL | 2.90 | 3.25 | 3.60 | 4.30 | 4.90 | 4.90 |
| Deferred net interest deduction carryforward | 0.90 | 1.65 | 2.25 | 2.55 | 2.45 | 1.35 |
Pass-through entities
20 percent pass-through deduction in a nutshell

- Applies to operating income of active businesses
- Does not apply, generally, to professions or financial businesses
- Business must either:
  - Pay W-2 wages equal to 40 percent of income to get the full 20 percent deduction
  - Limit deduction to 2.5 percent of original cost of depreciable, tangible property plus 25 percent of wages
- Business type and wage/asset limits do not apply below specified income limits
Problems and issues

• Employee versus independent contractor?
  − Conversions under $315,000?
• Are all ‘service businesses’ without large physical plants disqualified because their ‘principal asset’ is the skill and reputation of their employees or owners?
• Are dermatology clinics forbidden, but tanning salons allowed?
  − Is there a better way?
• Can an owner without wages or assets pay himself a wage and get a 14 percent deduction, in effect?
  − Can partners be employees?
• Will ‘reasonable compensation’ rules apply to S corporations?
  − Will they apply to partnerships or proprietorships?
Specified service businesses

- No benefits (above the income threshold) for owners of ‘specified service businesses,’ defined as:
  - Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or
  - Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees [OR OWNERS]

- What does this mean?
State tax considerations
State tax considerations

- A question of conformity to federal changes
  - Rolling, fixed, selective
- Some provisions broaden the federal income tax base (e.g., interest expense limitations)
  - Potential windfall for states
- Some provisions allow deductions from the federal income tax base (e.g., bonus depreciation)
  - Anticipate decoupling for state purposes
- Other state responses
  - State income tax systems and rates could change
  - Deduction and exemption eliminations, base expansions and new taxes, e.g., gross receipts taxes
- Many planning opportunities exist
  - Location selection, nexus
  - Choice of entity and state specific elections
  - Capital expenditures, section 179
  - Credits and incentives
Base erosion/anti-abuse tax (BEAT)
BEAT: Base erosion and anti abuse tax

- BEAT (effective for tax years beginning after Dec. 31, 2017)
- 10 percent additional ‘minimum’ tax on U.S. corporations (5 percent for 2018, 12.5 percent after 2025)
- Applies where 10 percent of ‘modified taxable income’ (MTI) exceeds regular tax without R&D and a few select tax credits
- MTI is taxable income without regard to base erosion tax benefit (i.e., no deduction for base erosion payments)
- Base erosion payments include any deductible amount paid/accrued to a foreign related party
- Includes payments for depreciable property or insurance payment
- Excludes items that reduce gross receipts (like cost of goods sold)
- Threshold for related party status 25 percent vote or value
BEAT: Applicability

- BEAT applies to U.S. corporations not treated as flow-through (e.g. S corps, REITS, RICs)
- $500 million of domestic gross receipts if base erosion percentage is 3 percent or higher
- Members of U.S. consolidated group are treated as single corporation (IRC section 1563(a))
- Significant diligence item on acquisition of companies in excess of $500 million in revenue
BEAT: Other considerations

- **BEAT payments:**
  - Any deductible amount paid/accrued to a foreign related party unless it is subject to U.S. statutory withholding tax
  - Excludes:
    - Certain items that reduce gross receipts (COGS)
    - Certain services without markup

- **Business credits:**
  - R&D credit – full offset.
  - Section 38 credits (investment tax credit, production tax credit) – 80 percent offset
  - Credit offsets sunset after 2025

- **Reporting:**
  - Section 6038A regime (Form 5472)
  - Penalty for noncompliance increased from $10,000 to $25,000
# BEAT: Example

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount 1</th>
<th>Amount 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable taxpayer’s TI</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Base erosion tax benefits</td>
<td>$300</td>
<td>$700</td>
</tr>
<tr>
<td>MTI</td>
<td>$800</td>
<td>$1,200</td>
</tr>
<tr>
<td>10% of MTI (A)</td>
<td>$80</td>
<td>$120</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td><strong>Reg. tax rate</strong></td>
<td><strong>21%</strong></td>
<td><strong>21%</strong></td>
</tr>
<tr>
<td>Reg. tax liability</td>
<td>$105</td>
<td>$105</td>
</tr>
<tr>
<td>Adjust for applicable credits (B)</td>
<td>&lt;$5&gt;</td>
<td>&lt;$5&gt;</td>
</tr>
<tr>
<td>Reg. tax liability (C)</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Base erosion minimum tax amount (A) – (C)</strong></td>
<td>$0</td>
<td>$20</td>
</tr>
</tbody>
</table>
BEAT: Next steps and planning opportunities

- COGS
- Intercompany debt
- Transfer pricing
  - Services
  - Royalties
  - Other
Anti-hybrid provisions
Hybrid transactions

- The Act denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by or to a hybrid entity
  - A ‘disqualified related party amount’ is any interest or royalty paid to a related party where the related party (1) does not include the payment in its income in the country in which it is a resident or (2) is allowed a deduction with respect to the amount in the country in which it is a resident
  - A ‘hybrid transaction’ is any transaction, series of transactions, agreement, or instrument where one or more payments is treated as interest or royalties for U.S. federal tax purposes but not treated as interest or royalties by the country in which the related party is resident
  - Largely based on OECD BEPS recommendations with a few modifications
• A ‘hybrid entity’ is any entity that is:
  − Fiscally transparent for U.S. tax purposes but not transparent under foreign law, or
  − Fiscally transparent for foreign law purposes, but not transparent for U.S. tax purposes
• Rulemaking authority is delegated to the Treasury to provide rules:
  − Denying deductions for conduit arrangements that involve a hybrid transaction or hybrid entity
  − Applying the provision to foreign branches
  − Applying the provision to ‘certain structured transactions’
  − Denying all or a portion of a deduction claimed for interest or royalties paid that are subject to certain preferential tax regimes or a participation exemption system
  − Determining the tax residence of a foreign entity
  − Identifying exceptions to the general rule
Foreign derived intangible income deduction (FDII)
### Foreign derived intangible income deduction (FDII)

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| FDII (effective for tax years beginning after Dec. 31, 2017) | • Deduction results in an effective 13.125 percent  
• Applicable for Domestic C corporations with gross income generated by revenues to foreign customers for foreign use  
• Products and services revenue with respect to property not located within the United States  
• Requires base calculations of ‘tangible’ income and intangible income | • Consider using C corporations to take advantage of FDII deductions  
• Need to identify and document qualification of this deduction  
• Sales to domestic unrelated parties before final overseas sale eliminates benefit  
• New diligence item |
Additional issues applicable to foreign-owned U.S. companies with foreign subsidiaries
# International tax provisions: GILTI minimum tax

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| Global Intangible Low Taxed Income (GILTI) (effective for tax years beginning after Dec. 31, 2017) | • Targeted at foreign corporations that earn a high rate of return on their intangible assets  
  • Much broader than intangible holding companies  
  • All industries  
  • Calculates tax on amount over net deemed tangible income  
  • GILTI applies to any controlled foreign corporation (CFC)  
  • C corporations receive a deduction against GILTI equal to 50 percent | • Expectation is that many CFCs will be subject to GILTI  
• Effectively a 10.5 percent minimum tax CFC is owned by a domestic C Corp  
• Eligible for partial foreign tax credit offset  
• New diligence item |
### International tax provisions: Repatriation and DRD

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| One-time deemed repatriation tax on foreign deferred earnings (effective for tax years beginning before Jan. 1, 2018) | • Foreign deferred earnings are taxed at 15.5 percent or 8 percent based on balance sheet attributes (cash & cash equivalents vs. non-cash assets, respectively)  
• Election to defer payment over eight years | • Determine applicability at portfolio and owner level  
• Significant diligence item as well as cash flow concern  
  • Need to understand earnings and profits on all impacted companies  
• Many states will treat the repatriation as Subpart F income subject to full or partial dividend received deduction |
| Dividend received deduction/participation exemption (effective for distributions made after Dec. 31, 2017) | • Certain foreign dividends non-taxable in the United States  
• Certain gains on sale of foreign subsidiaries will not be subject to U.S. federal income tax | • Applicable to C-corporations with foreign corporation(s)  
• Corporate structure may be benefit due to participation exemptions |
Stock attribution rules
Stock attribution: Key reform changes

- Where a U.S. entity is owned by a foreign entity filing may be required with respect to foreign corporations owned by the foreign parent entity
- U.S. members of foreign group with ownership in foreign entities may have to consider income inclusions
  - Applies only if U.S. members have a direct or indirect ownership
  - Can apply to minority interests in entities that were not CFC’s under former rules
- Rule could be highly relevant to foreign inbound companies and PE funds using foreign holding funds
- May impact certain ownership structures that were put in place to avoid CFC and Subpart F implications by manipulating voting rights
- Need to review global ownership structures of potentially relevant entities
- Retroactive effect – thus impacting the 2017 tax year
Stock attribution: Example

Results of striking IRC section 958(b)(4):

U.S. sub is treated as owning 100 percent of Foreign Sub for purposes of determining whether Foreign Sub is a CFC (i.e. downward attribution from a foreign person)
Tax planning opportunities
Tax planning opportunities

- **Accelerate deduction/defer income in 2017**
  - Cost segregation studies – new construction, existing buildings purchased or renovations in current year or prior years
  - Maximize depreciation deductions/tangible asset regulations
  - Review accounting methods for potential changes
    - Deduction of prepaid expenses
    - Maximize deductions of accrued expenses
    - Deferral of advanced payments
    - Deferral of trade discounts
Tax planning opportunities (cont.)

• Entity choice –
  − Any pass-through entities will want to reevaluate the benefits of their pass-through status
  − Corporate tax rates have been slashed from 35 percent to 21 percent
  − Pass-through businesses such as S corporations and partnerships may now qualify for a new pass-through deduction that would effectively cut their tax rates from 39.6 percent to 29.6 percent
  − Fundamental international tax reform will have dramatic consequences for those businesses that are internationally active
  − Must consider exit strategy and level of anticipated distributions
What are companies doing now?

- Consider impact of federal tax reform on consequences to state taxable income
- Calculating impact on tax provision – ASC740 reporting
  - Tax reform is enacted or substantively enacted
  - Projecting both U.S. and global tax positions – considering all new law
- Deemed repatriation tax
  - Calculating earnings and profits and foreign tax credits
  - Planning for impact of anticipated repatriation and taxes due at April 15
- BEAT – does the business have base eroding related party payments?
  - Identify any potential planning or supply chain changes
  - Consider withholding tax implications
- Interest limitations
  - Review global debt position to identify any potential interest limitations consider alternative financing structures
- Anti-hybrid
  - Review structure and intercompany transactions for potential impact
- Supply chain – U.S. may be a more favorable location for assets, functions and risks
  - Review existing global supply chain and pros/cons for locating in the U.S.
Tax reform resource center

Visit our tax reform resource center for more information on how legislation can affect your business and tax planning. www.rsmus.com/taxreform
Thank you

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Thank you for your time and attention