International Corporate Reorganizations - US tax reform

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By:

On 22 December 2017, President Donald Trump signed a comprehensive US tax reform bill known informally as the "Tax Cuts and Jobs Act" (TCJA).

The following TCJA provisions in particular are expected to have a significant impact on M&A and reorganization activity (both external and internal):

1. Corporate rate reduction

   The US federal corporate income tax rate has been reduced from 35 percent to 21 percent. This rate applies to income earned both by US corporations and by US-based branches of foreign companies.

   In general, the rate reduction will reduce the tax benefit to be gained by stripping earnings out of the United States via interest payments, and may also incentivize groups to restructure so royalty and interest payments flow into the United States from jurisdictions with a higher corporate tax rate (depending on tax rates and deductibility limitations in the paying jurisdiction). When combined with other new IP-related incentives (such as a new domestic quasi-patent box system known as Foreign-Derived Intangible Income or FDII, discussed below), it may also spur US groups to repatriate IP that had been shifted to offshore jurisdictions.

2. Repatriation tax

   A new "repatriation tax" generally subjects US shareholders of foreign corporations with a 10-percent or greater equity interest to a tax on their share of the relevant foreign corporation's accumulated untaxed profits – regardless of whether the US shareholders actually repatriate cash or other assets from offshore – for tax years ending on 31 December 2017 or during 2018. Once taxed, the offshore earnings can generally be invested in the United States free of additional US tax consequences. This newfound flexibility is expected to spur additional acquisition and reorganization activity in the coming years.

3. Anti-hybrid rule

   A new "anti-hybrid" rule generally disallows deductions against US taxable income on payments made to foreign affiliates by US entities or non-US entities with US branch activities when such deductions are achieved through hybrid entities (entities treated as fiscally transparent in one jurisdiction but opaque in the other) or hybrid transactions involving interest or royalties (for example, pursuant to an instrument treated as debt in the United States but equity in the payee's jurisdiction). The anti-hybrid rule is expected to have a substantial effect on the hybrid shareholder debt previously used by many non-US MNEs to strip earnings out of US group entities via interest deductions, and is also expected to reduce or eliminate the effectiveness of a number of standard IP holding company structures.

4. Limitation on interest deductions

   A new, stricter earnings-stripping rule generally limits a US taxpayer's net interest deductions to 30 percent of its adjusted taxable income. Unlike the prior earnings-stripping rule, the new rule applies to both related and unrelated indebtedness, and does not provide for any safe harbor based on an entity's debt-equity ratio.

   This rule is expected to disincentivize "debt push downs" to US entities in a post-acquisition restructuring, particularly when combined with the lower corporate rate.

5. Minimum tax triggered by related-party deductible payments (BEAT)

   A new minimum tax – the Base Erosion and Anti-Abuse Tax (BEAT) – affects large taxpayers claiming a threshold amount of deductible payments to non-US related parties. Very generally, the tax is intended to approximate the US income tax that would have applied to an entity had certain deductible cross-border payments not reduced the entity's taxable income base.

   Critically, payments for gross receipts (ie the cost of goods sold) are not considered to be a disfavored base-eroding payment, which should largely insulate US manufacturers and retailers from the scope of the BEAT.

   To address these concerns, groups are expected to make internal legal and business changes that include the following: (1) using unrelated intermediaries to receive "bad" BEAT payments; (2) recharacterizing certain payments as COGS; and (3) checking foreign subsidiaries "open" for US tax purposes so that affiliate payments potentially within the scope of BEAT are not recognized for US tax purposes.

6. Technical changes

   A number of changes implemented under the TCJA increase the likelihood that minority US shareholders in foreign groups will be subject to US tax on notional or deemed dividends for US tax purposes (Subpart F or GILTI inclusions) by virtue of their ownership interest.

   The TCJA accomplishes this in part by expanding the definition of "Controlled Foreign Corporation" (CFC) to include certain foreign entities that are not majority-owned, directly or indirectly, by US individuals or corporations. This expanded definition will make it more difficult to unwind "sandwich structures" resulting from acquisitions of US businesses by foreign groups.

7. GILTI/FDII

   A new provision known as the Global Intangible Low-Taxed Income (GILTI) regime expands the range of CFC income potentially subject to current inclusion in the hands of a US parent or other substantial equity holder. The GILTI regime very generally requires a US 10-percent (or greater) shareholder to recognize a portion of CFC earnings currently to the extent those earnings exceed a notional amount representing a 10-percent return on the CFC's tax basis on certain types of depreciable, tangible assets. Because of the GILTI provisions, US businesses or individuals will find it significantly more challenging to defer income from US taxation merely by housing assets or operations in non-US subsidiaries. GILTI is also expected to spur US groups to repatriate IP back to the United States.

   Conversely, the TCJA provides for a new preferential rate of tax on income earned directly by US corporations (FDII) on foreign-directed sales or licenses that are, very generally, attributable to the exploitation of intangible assets. The FDII regime represents yet another incentive for US groups to repatriate IP assets currently owned by CFCs, providing the IP is managed at least to some extent by US-based employees.