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Under the microscope

What US tax reform means for multinationals

Key elements of US tax reform

On December 22 2017 the Tax Cuts and Jobs Act (the TCJA) was signed into law. The TCJA represents the most significant changes to the US Internal Revenue Code since the Tax Reform Act of 1986 and means that US multinationals - and non-US multinationals with US operations - need to reassess how they do business.

The centerpiece of the TCJA is the reduction in the US corporate tax rate from 35% to 21%. This rate reduction is intended to make the US a more competitive jurisdiction and increase inbound business investment.

In consideration of the reduced rate of US corporate tax, certain other provisions seek to broaden the US tax base. One such provision generally limits the deductibility of business interest to the sum of business interest income and 30% of the taxpayer's adjusted taxable income. The US also adopted a new base erosion and anti-abuse tax (BEAT). BEAT is effectively an alternative minimum tax for certain large corporations that is calculated by adding back certain deductible payments made to related parties. Deductible payments at issue include related party interest that is not subject to the limitation described above. The BEAT rate is 5% in 2018, which increases to 10% in 2019 and then 12.5% in 2026. US corporations are liable for BEAT to the extent it exceeds their regular tax liability.

The TCJA transitions the US toward a territorial system. As a result, future non-US earnings repatriated from non-US corporations should be exempt from US tax, assuming ownership thresholds are met. As part of this transition, a mandatory one-time transition tax is imposed on a US shareholder's interest in the untaxed accumulated earnings of certain non-US corporations, effectively at rates of 15.5% to the extent of cash/liquid assets and 8% on the remainder of such earnings.

The quasi-territorial nature of the system is illustrated by the adoption of a new tax on global intangible low-taxed income (GILTI). GILTI is broadly defined and requires a US shareholder to include in income its

pro rata share of the income of its controlled non-US subsidiaries, subject to certain exclusions. GILTI operates, in effect, as a current worldwide minimum tax on income of controlled foreign corporations. This is a significant change from the pre-TCJA rules, where non-US earnings were not included in income of a US shareholder until repatriated or otherwise subject to certain other anti-deferral rules, such as the subpart F regime which remains in effect.

Corporate US shareholders generally receive a deduction equal to 50% (decreasing to 37.5% in 2026) of their GILTI and, subject to applicable limitations, foreign tax credits (FTCs) for 80% of the taxes paid by non-US subsidiaries in respect of such earnings. As a result, for corporate US shareholders able to fully utilize FTCs, GILTI will only be subject to residual US tax if the blended rate of non-US tax on such earnings is less than 13.125%.

The new deduction for the foreign derived intangible income (FDII) of US corporations is a corollary to the GILTI rules. The deduction is equal to 37.5% (decreasing to 21.875% in 2026) of a US corporations' FDII, which generally includes a portion of corporation's income from the sale of goods, services and intangibles to unrelated non-US parties. The impact is that FDII is generally subject to an effective US tax rate of 13.125%. The legislative history indicates that GILTI and FDII are intended to make US corporations indifferent as to whether sales and licenses to non-US persons are made directly from the US or through non-US subsidiaries in lower tax jurisdictions.

The TCJA also includes provisions that are similar to guidance provided by the Organization for Economic Cooperation and Development's (OECD) Base Erosion and Profits Shifting (BEPS) project and the European Union's Anti-Tax Avoidance Directive (ATAD). Specifically, the US adopted a provision that disallows a deduction for interest or royalties paid or accrued to a related party pursuant to a hybrid transaction or by, or to, a hybrid entity.

What does it mean?

The changes enacted by the TCJA are significant and it is imperative that multinationals consider the impact on their existing structures. As an initial matter, the reduced 21% US corporate tax rate makes the US a more attractive jurisdiction in which to invest and non-US parented multinationals with significant US operations may face pressure to "come back" to the US.

After the mandatory one-time transition tax and the exemption from tax on the repatriation of future non-US earnings from certain non-US corporations, US multinationals likely will consider repatriation of excess cash held offshore. Prior to engaging in any such repatriation, consideration should be given as to how any distributed non-US earnings are sourced, the impact of a US shareholders' stock basis in the distributing corporations (and the related potential for US capital gain recognition), foreign currency implications, and potential non-US withholding and income taxes incurred on distributed amounts and the US creditability of such taxes. In addition, consideration must also be given to whether there are local limitations on the ability to distribute cash to the US.

Legacy corporate structures established prior to the TCJA may have historically helped to facilitate tax efficient US repatriation. Legal entity rationalization opportunities may exist for these structures given the changes noted above.

Corporate restructurings, certain elections, or changes to an existing supply chain could provide a more efficient GILTI profile. Further, planning may be available to preclude non-US earnings from current US taxation under GILTI or otherwise enhance the overall FTC profile of the US taxpayer.

The capital structures of US corporations need to be reevaluated in light of the new limits on the deductibility of business interest. Taxpayers may find that debt is more appropriately located at the level of non-US subsidiaries in US multinational groups, or that a US corporation in a non-US multinational group is more appropriately funded with equity.

While the reduced rate of US tax for FDII is attractive, companies may want to pause before restructuring operations on this basis. The deduction for FDII may be challenged on trade law grounds, the effective rate of tax on FDII increases to 16.4% beginning in 2026 (when the deduction decreases to 21.875%), and a transfer of intangibles and/or operations may trigger significant local or US tax costs.

In light of BEAT, US multinationals should analyze amounts paid to related non-US persons and potentially consider supply chain changes. It should be cautioned, however, that Congress has granted Treasury with broad authority to issue anti-abuse regulations or other guidance.

Concluding comment

The TCJA enacted significant changes relevant to both US multinationals and non-US multinationals with operations in the US. Multinationals should consider the impact of these changes on their structures and determine if corporate restructuring or changes to business operation are required. While it may be premature to engage in large-scale restructurings, multinationals are likely to find that opportunities exist to modernize or otherwise rationalize their existing structures.

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