

Reflections On US Tax Reform

Near the end of 2017, the US Congress and the Trump Administration enacted the most comprehensive reforms of the US federal tax system in more than 30 years, with many of its provisions taking effect on January 1, 2018 (US Tax Reform). While it may not have been all that the business community hoped for, it certainly has given taxpayers, both in the US and around the world, plenty to ponder, analyze and consider with respect to planning.

This newsletter provides our thoughts and reflections on the core international provisions introduced by the legislation, often referred to as the Tax Cuts and Jobs Acts (TCJA). With the benefit of having seen US Tax Reform “in action” over the last few months, we set out some of the key issues and challenges, as well as the potential opportunities, most commonly encountered by multinationals with US business interests.

The TCJA is likely to have its most significant impact in three areas:

- 1. US outbound investment** – Through the “participation exemption,” Global Intangible Low-Taxed Income (GILTI), and Foreign Derived Intangible Income (FDII)
- 2. US inbound investment** – Through lower corporate tax rates and the Base Erosion and Anti-abuse Tax (BEAT)
- 3. Investment through partnerships and other pass-through entities**

This article examines each of these areas in more depth. Two further broad points are also worthy of exploration:

- 1. US Tax Reform is not complete** – Businesses need to be alert, ready to track and, where necessary, ready to engage with regulatory guidance on the TCJA and the potential for “phase two”

2. US Tax Reform will not operate in isolation – The impact on, and interaction with, global efforts to reform the framework of international tax rules, and other nations’ efforts to reform their own tax systems, has created a complex global web of interconnected tax rules whose reach and impact should not be underestimated.

In order to provide some context, this article briefly outlines some of the main business tax reforms contained in the TCJA.

Summary of Key Business Reforms

Corporate Income Tax Rate Reduction

The corporate tax rate has been reduced from 35% to 21%.

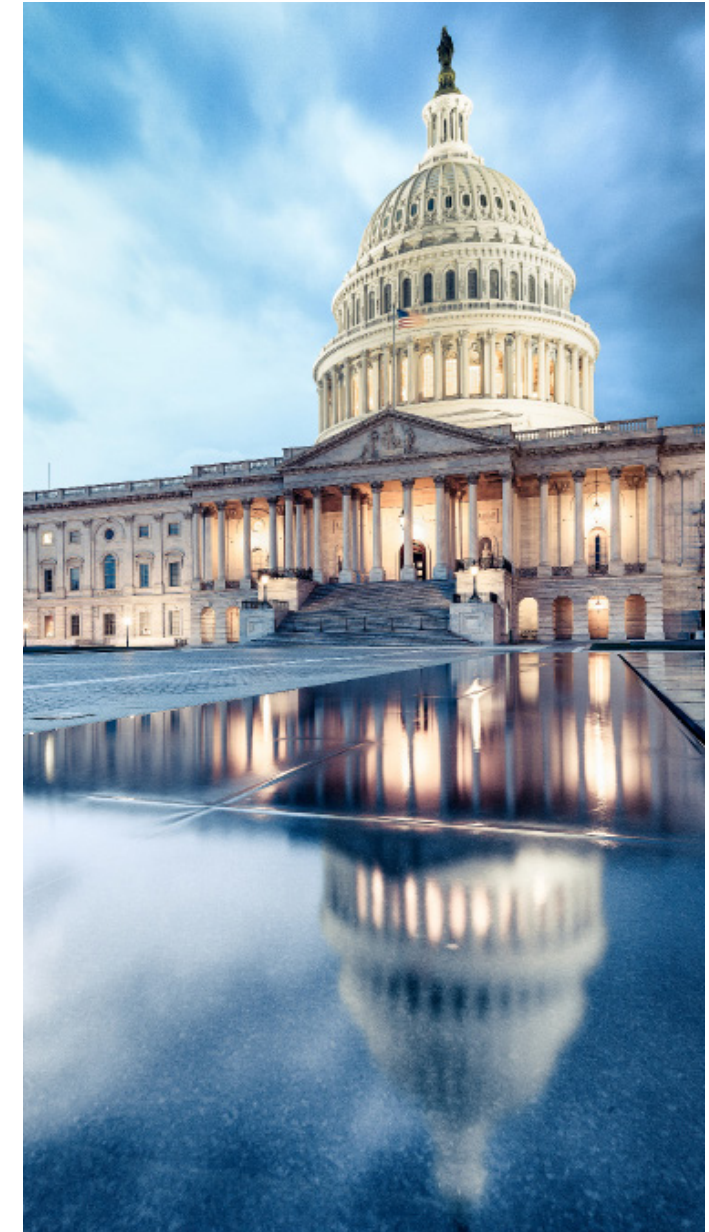
Net Interest Expense Restriction

The deduction for net interest expense is now limited to an amount equal to 30% of:

- EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) for four years
- EBIT (Earnings *before* Interest and Taxes but *after* Depreciation and Amortization), which is closer to a company’s operating income, after 2021

Other key features of the net interest expense limitation are:

- An unlimited carry-forward for any disallowed interest deductions
- No exemption for interest on debt incurred before the legislation was enacted (i.e., the limitation applies to interest on new and old debt)
- The limitation applies to interest paid to both related and unrelated creditors (although, importantly, there are additional potential limitations for corporations in the case of cross-border interest payments to foreign related parties)





The net interest expense limitation does not apply to:

- Certain, yet-to-be fully defined, real estate businesses that may be able to elect out of the interest limitation (although, doing so will mean those businesses lose the temporary right to immediately expense 100% of the acquisition cost of otherwise eligible property)
- Businesses with less than US\$25 million in gross receipts (with related corporations being aggregated for this purpose)

The limitation applies to partnerships and corporations. In the case of partnerships, the limitation is calculated at the partnership level and partners are generally allowed to use the partnership's unused limitation. If a partnership's EBITDA/EBIT exceeds 30% of its interest expense, the "excess taxable income" is passed through to partners for use in determining their limitations on other interest expense.

Cost Recovery

A commonly overlooked, yet very significant, provision of the TCJA allows a temporary right to expense immediately 100% of the acquisition cost of certain new or used *tangible* property (other than land and buildings) acquired after September 27, 2017 and before January 1, 2023, with the expensing percentage declining after that date.

Net Operating Losses

Net operating losses (NOLs) incurred after 2017 may:

- Be carried forward indefinitely, but
- Not be carried back to prior years, and
- Only be used to offset 80% of taxable income in a given taxable year

International – Deemed Repatriation

Prior years' earnings of most foreign corporations with 10% US shareholders (at least one of which is a US corporation) are, to the extent not previously subject to US tax, deemed to have been repatriated and will be subject to US tax immediately.

The tax rate applicable depends on how the earnings have been invested:

- Cash or cash equivalents = 15.5%, and
- Other assets = 8%

Taxpayers can elect to pay the tax over a period of years. Individuals who are US shareholders of controlled foreign corporations are also hit with this deemed repatriation tax at somewhat higher rates.

International – Modified Territorial System

For non-US earnings after 2017, the TCJA replaces the prior "worldwide" system of taxing income earned by a US corporation through foreign subsidiaries with a modified "territorial" system. While the TCJA did little to change provisions that potentially tax offshore income as it is earned (other than the new GILTI regime described below), it made significant changes to the treatment of such income when it is distributed.

Two main features characterize the new system:

• Participation Exemption

US Tax Reform introduces a new "participation exemption" for 100% of the foreign source portion of dividends received by a US parent corporation from a 10% or greater owned foreign subsidiary corporation. This operates by means of a deduction and, unlike other participation exemption regimes around the world, does not limit US tax on the sale of offshore shares.

Notably, the new participation exemption is not available for "hybrid dividends" (i.e., dividends where the payer receives a deduction or other tax benefit under applicable foreign law).

• CFC Rules

The US "Subpart F" (i.e., controlled foreign corporation [CFC]) rules have not been significantly modified by TCJA. As a result, some categories of income (e.g., certain types of passive income) earned by a CFC are still subject to full US taxation, in the hands of the US parent shareholder, on a current basis.

There is still some uncertainty related to how the CFC rules and the territorial system of tax will interact. As the Treasury releases more guidance on this issue, there may be planning opportunities available to maximize the benefits of participation exemption and minimize the impact of Subpart F.

International – GILTI and FDII

The introduction of a modified territorial system potentially creates (or increases) the incentive to move intangible assets or other income producing activities offshore. The TCJA adopts a dual approach to addressing this risk.

• Disincentive – GILTI

US Tax Reform introduces a minimum tax on GILTI to discourage the location of valuable income producing property offshore.

Computationally complex, the policy goal of GILTI is to subject offshore income that is above “routine returns” to current US tax. Despite its name, the GILTI tax is not limited to intangible income. GILTI applies to the aggregate income of all foreign corporate affiliates (with adjustments) to the extent that aggregate income exceeds a 10% return on the foreign affiliates’ “qualified tangible assets” (as defined). The excess is *deemed* income in the US unless or to the extent it is covered with a foreign tax credit (FTC) (i.e., it is taxed currently in the US if it is too “low taxed” offshore).

GILTI income is subject to additional tax in the US by restricting the participation exemption.

• Incentive – FDII

To counterbalance GILTI, the TCJA provides for a super deduction in the US for FDII – i.e., broadly, income earned overseas that is generated from property held in the US – thereby reducing the effective tax rate applicable to that income.

Again determined under a formula, FDII represents an approximation of the portion of the corporation’s total intangible-related income that is attributable to servicing foreign markets from the US.

International – BEAT

The Base Erosion and Anti-abuse Tax (BEAT) functions as a minimum tax and attempts to counter various profit-stripping strategies adopted by multinationals with US operations.

The BEAT applies by adding back (i.e., bringing back into tax by denying any deduction) certain specified “base erosion payments” made by certain US corporations. Once determined, the BEAT rate is 5% for 2018, rising to 10% for the period 2019 to 2025, before rising again to 12.5% from 2026.

International – Hybrids

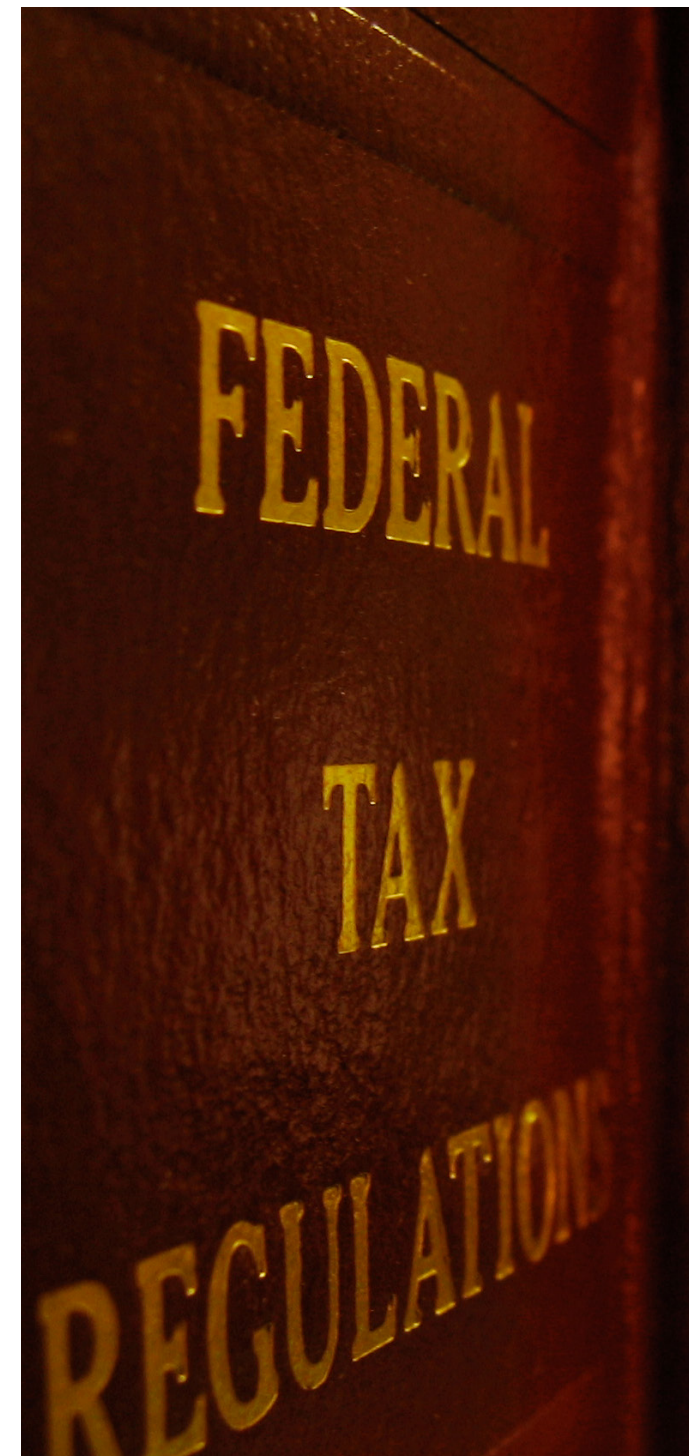
Cross-border payments of interest and royalties to related entities will not be deductible where either:

- There is no corresponding inclusion of income by the recipient, or
- The recipient is also entitled to a deduction because of the hybrid nature of the instrument (or the nature of the entities involved)

International – Disposition of Partnership Interests by Non-US Person

Non-US persons that sell or exchange interests in a partnership that is engaged in a US trade or business will now clearly be required to recognize “effectively connected income” (ECI) on the sale of the interest to the extent the partner would have realized ECI had the partnership sold all of its assets. This is a direct legislative rejection of recent US case law to the contrary.

A withholding tax equal to 10% of the amount realized by the selling partner will be imposed.





US Outbound Investment – GILTI and FDII

Two key sets of provisions of US Tax Reform affecting US-based multinationals operate in tandem. First, the rules affecting GILTI *discourage* non-US ownership of intangible property. Second, the rules on FDII *reward* retaining (or returning) intangible property to the US ownership.

The GILTI and FDII provisions work together to provide an overall deductible amount to US taxpayers selling outside the US by bringing into account “bad” income (i.e., high-return non-US generated income) under GILTI, and providing an enhanced deduction for “good income” (i.e., high-return US-generated income) under FDII.

The interrelationship between the relieving FDII and the taxing GILTI provisions operate as a “carrot” and a “stick” respectively to protect the US tax base.

The GILTI Stick

An important, overarching change to the US international tax regime under US Tax Reform is the move toward a generally “territorial” based tax system. As part of that, the US generally no longer taxes inbound dividends received by a US parent company from its controlled foreign subsidiaries – i.e., a participation exemption where the US parent company is entitled to a tax deduction equal to the dividend received.

One obvious risk of providing a full dividend deduction is that US corporations might see the opportunity to move (or retain) valuable intangible property in a low (or no) tax jurisdiction outside the US and bring the related income it generates home “tax-free.” GILTI seeks to prevent corporations’ exploiting that opportunity and so helps protect the US tax base.

In essence, GILTI operates by requiring a US parent corporation to bring certain types of high-return “GILTI income,” arising in certain low-tax jurisdictions, into account on a current basis. The dividend deduction available for GILTI income is restricted to 50%, resulting in an effective tax rate on GILTI income of 10.5% (the main rate of corporate income tax now being 21%). From 2026, the deduction is further restricted to 37.5%, resulting in an effective tax rate on GILTI income of 13.125%. In order to fully cover GILTI with FTCs, the effective offshore rate must be somewhat higher, as described below.

Importantly, although primarily aimed at intangible property (being the easiest and quickest to move to low-tax jurisdictions), because of the formulaic way in which it is calculated, GILTI income is not necessarily limited to earnings from intangible assets or to low tax jurisdictions. A US parent company’s GILTI income is, broadly, its subsidiary’s net income (excluding any income that has otherwise already been included in US taxable income) as reduced by both interest expense and “Qualified Business Asset Investment” (QBAI), that is a proportion of the subsidiary’s aggregate adjusted bases in tangible and depreciable property.

The net result will be current US tax on certain higher than routine returns on assets that are earned in lower tax countries. This represents an important, and significant, restriction on the extent to which US Tax Reform has moved the US to a “territorial” tax system.

To complicate matters further, although the new rules do allow an FTC for GILTI income, that FTC is limited to 80% and there is a separate GILTI “FTC basket” and no ability to carryforward, or carryback, the FTC. In practical terms, this means foreign taxes paid on income arising from other sources cannot be aggregated with foreign taxes paid on GILTI income for FTC purposes – once GILTI, always GILTI.

Prior to 2026, the minimum applicable foreign tax rate that will mean there is no requirement to include GILTI income (after application of the 80% FTC) is 13.125%. The minimum threshold rate increases to 16.40625% in 2026.

Although it is not included as Subpart F income of a US parent, GILTI income is treated in a similar manner to Subpart F income for other purposes. For example, GILTI income is treated as a “deemed dividend” and so will be treated as previously taxed income if a cash dividend is later made from the relevant subsidiary.

Many questions about the practical application of the GILTI stick remain unanswered. The most obvious areas that need further clarification and guidance include:

- Whether GILTI income should be calculated by reference to individual US shareholder companies, or whether it should (or can) be calculated jointly within a consolidated group or sub-group
- Whether (and if so how) GILTI income, losses and FTCs can be netted

The FDII Carrot

Although the “GILTI stick” reduces the potential return from moving valuable intangible assets to jurisdictions with a lower tax rate than the US (or keeping intangible assets in such jurisdictions) it does not eliminate the incentive – an effective rate of 10.5% on GILTI income is still “better” than 21% on US corporate income.

Designed to work alongside GILTI, the FDII provisions included in US Tax Reform are intended to incentivize US companies to keep (or return) intangible assets in the US. The “FDII carrot” is a new tax deduction for a US company for its “FDII income” (i.e., broadly, income from export services and product sales to non-US customers) generated from certain assets owned by that company.

Like GILTI, and despite its name, the FDII special deduction is available to certain high-return export business activities and operates in a similar manner to many other countries’ “patent box” regimes. Once calculated, a corporate taxpayer can claim a tax deduction equal to 37.5% of its FDII income, resulting in an effective tax rate of 13.125%. The level of deduction drops to 21.875% (resulting in an effective tax rate of 16.40625%) for taxable years beginning after December 31, 2025.

As with GILTI income, the computation of FDII income is formulaic and, potentially at least, is not restricted to pure intangible assets in its traditionally understood form.

Investment Decisions

US-based multinational companies should continue to identify ways to maximize their returns in the new, post-TCJA environment. In fact, many companies are already in the process of analyzing their supply chains to determine whether restructuring will be beneficial.

While the new corporate tax rate of 21% is substantially lower than the previous rate (35%), in many cases, it is still not low enough to persuade the companies targeted by the GILTI and FDII provisions to rearrange their affairs fundamentally. This is because most US companies that have intangible property holding company structures are still able to achieve an overall effective rate significantly below 21%, despite the GILTI stick and FDII carrot.

To protect US businesses and jobs, President Trump has again hinted at some form of “border adjustment tax” (originally included in the House Bill for US Tax Reform but subsequently dropped from the final version) to penalize imports. In light of this, the President’s decision to impose tariffs on a wide range of products, including solar panels, steel and aluminum, and risk embarking on a “trade war” (primarily aimed at, but not limited in effect to, China) is perhaps not coincidental.

Putting the issue of tariffs to the side, US multinationals will be following the international response to US Tax Reform, and the “FDII carrot” (perceived by many as incompatible with World Trade Organization [WTO] free trade rules) in particular, very closely.



US Inbound Investment – BEAT, Hybrids and Other Impacts

Another core principle of US Tax Reform was to encourage more inbound investment to the US. The TCJA contains income tax changes that will affect non-US institutional investors in potentially significant ways, but two questions immediately arise:

- How does the new law balance the protection of US businesses and jobs with incentivizing foreign direct investment?
- How successful will it prove to be?

These questions are particularly pressing because some provisions of US Tax Reform seem to discourage inbound investment. The provisions in question include:

- The Base Erosion and Anti-abuse Tax (BEAT)
- The rules targeting arrangements involving hybrid financial instruments and hybrid entities

The BEAT

Introduced as an alternative to the border adjustable tax (BAT), the BEAT is aimed (principally) at foreign-based corporate groups that engage in transactions with US-based related parties in order to reduce their US taxable income. The transactions used by companies could involve the use of intercompany debt (or other transactions and arrangements) in so-called “earnings stripping” strategies or it may involve a royalty payment from a US manufacturer to its parent, which is the intangible property owner. Because these strategies potentially have the ability to erode the US tax base, BEAT limits the effect of that erosion.

BEAT is an attempt to ensure that a “reasonable” level of US tax is paid on the US earnings of a US corporation, even though that corporation makes otherwise tax-deductible payments to foreign related entities. Such payments generally arise in connection with:

- Financial instruments (which will include interest payments)
- Intellectual property licenses (which will include royalty payments)

BEAT functions as a minimum tax. It is imposed on a US corporation’s “modified taxable income,” which is determined by adding back specified earnings stripping “base erosion payments,” made by the corporation, to its regular taxable income.

The BEAT actually payable by a US corporation is equal to the excess of:

- The amount determined by applying the “BEAT rate” to the “modified taxable income,” over
- The corporation’s regular tax liability

The BEAT rate is 5% for 2018, 10% for periods from 2019 to 2025 and 12.5% for all periods from 2026.

Special rules apply with respect to tax credits otherwise allowable in computing regular tax liability.

Base Erosion Payments

“Base erosion payments” will generally include all payments to related foreign entities that generate a US tax deduction (or other tax allowance) for the US corporation making the payment. However, certain deductible payments are excluded, including those:

- Subject to US withholding taxes
- For certain intra-group services
- That enter the “cost of goods sold” (COGS) computation
- For qualified derivative payments

BEAT Threshold

The BEAT applies only to US corporations that have average annual gross receipts of at least US\$500 million.

Even in such cases, however, the BEAT does not apply to a US corporation if the total “base erosion tax benefits” are less than 3% of the relevant corporation’s total deductions.

It is important to remember that the BEAT can also apply to any foreign corporation that is engaged in a US trade or business (e.g., through a US branch) that generates income taxable in the US in the form of an ECI.

Impacts of BEAT

While the intention of BEAT is to limit US base erosion, it may have the effect of discouraging US investment, particularly by way of manufacturing jobs, in the US. For example, a non-US intellectual property (IP) owner that licenses intangible property to its US subsidiary to manufacture products in the US could be discouraged from doing so due to the BEAT tax associated with the outbound royalty payment, even though such supply chain changes would result in the creation of US manufacturing jobs.

BEAT Guidance

Representatives of the IRS have indicated guidance on BEAT will be issued later this year. In particular, they noted the guidance will address how BEAT will be applied in the partnership context. Specifically, they believe guidance is required regarding who the relevant taxpayer and transactions will be – e.g., do we look at the partnership or partner level?

Anti-hybrids

Effective for taxable years beginning after 2017, the TCJA disallows deductions for payments of interest or royalties by a US corporation if neither the recipient nor a related party includes the payment in income by reason of either:

- The characterization of the payment under applicable foreign law (i.e., the hybridity of the instrument or payment), or
- The tax transparency of the recipient or related party (i.e., the hybridity of an entity)

The TCJA also provides the Treasury Department and IRS with broad regulatory authority to address arrangements, including conduits, intended to avoid the new anti-hybrid rules. The provisions are similar in many ways to the recommendations arising from OECD BEPS Project, Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements).

In addition, a related provision of the TCJA denies the benefits of the new participation exemption for certain CFC dividends where the CFC paying the dividend (or a related party) is allowed a deduction or similar tax benefit under applicable foreign law with respect to the payment.

Multinational businesses will need to analyze the hybrids in their group structures and should do so promptly given the immediate effective date.

Partnerships and Pass-Throughs

The US Tax Reform package included several significant measures affecting partnerships and other pass-through entities. Although most attention has focused on the deduction for 20% of pass-through income, there are other important changes as well.

Pass-Through Income Deduction

New rules allow individuals, trusts and estates to deduct 20% of their “qualified business income” subject to several significant caps and limitations. While the provision is often referred to as the pass-through entity deduction, the deduction applies to qualified business income earned directly by individuals and taxable trusts and estates (e.g., as independent contractors or through proprietorships) and to their share of qualified business income from pass-through entities.

Congress approved the new deduction in response to complaints from business people operating through pass-through entities that all businesses should benefit from rate reduction, not just corporations. The deduction is very valuable, particularly if almost all of a taxpayer’s income qualifies. In a progressive tax system, a percentage reduction in taxable income often will lead to a greater percentage reduction tax liability.

The deduction has a complicated set of limitations and restrictions that has left taxpayers confused as to how or whether the provision will apply to their activities. It has left other taxpayers surprised to find that they will benefit from the deduction. The need for guidance from the Treasury on key issues and the possible need for technical corrections have stymied tax planning to take advantage of the deduction. To date, Congress has passed one set of corrections to address some unintended results for the agriculture industry.

Under the **general rule**, the deductible amount for a qualified trade or business (discussed below) is 20% of the taxpayer’s “qualified business income” from the qualified trade or business, subject to a cap of the greater of:

- 50% of the “W-2 wages” with respect to the trade or business, and
- The sum of 25% of the W-2 wages with respect to the trade or business and 2.5% of the unadjusted basis of all qualified property calculated under special rules that ignore bonus depreciation

The cap does not apply to the calculation under the **special rule**. The special rule applies to taxpayers if the taxpayer’s taxable income (before the new deduction) does not exceed US\$157,500 (or US\$315,000 for taxpayers filing joint returns) as indexed for inflation. The benefit of the special rule is phased out over the next US\$50,000 of income (US\$100,000 for taxpayers filing a joint return).

A “qualified trade or business” is as any trade or business other than a “specified service trade or business” or the trade or business of providing services as an employee. “Specified trade or business” includes 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, investing and investment management, or trading or dealing in securities, partnership interests or commodities, as well as “*any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.*” The italicized language is a potentially large catchall for which there is little guidance. The legislation excluded “engineering” and “architecture” from the specifically enumerated specified services and Treasury officials have indicated informally that the italicized language would not pick up architectural and engineering firms.

A taxpayer who is eligible for the special rule can claim the new deduction with respect to nonemployment income from specified service trades or businesses. For example, a lawyer, accountant or physician, whether practicing alone or as a partner in a firm, can claim a full or partial deduction if the professional files a joint return with a spouse and the couple has taxable income (before the new deduction) of US\$415,000 or less. The deduction is available even if the partnership or proprietorship has no W-2 wages and no unadjusted basis in qualified property. This will put greater pressure on the employee – independent contractor distinction. For example, a counsel employed by a law firm is not eligible for the new deduction, but a counsel properly treated as an independent contractor is eligible.



Qualified business income is generally net income effectively connected with the conduct of a trade or business in the United States. The term excludes:

- Short- and long-term capital gain or loss
- Other investment income, such as dividends, income equivalent to a dividend, interest income other than interest income properly allocable to a trade or business, amounts received from an annuity not received in connection with a trade or business, and other similar items
- “Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business”
- Any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to a trade or business and, to the extent provided in the regulations, a payment described in section 707(a) for services

The purpose of the “reasonable compensation” exclusion is unclear; it apparently does not require a partner to treat a share of the partners’ share of profits or an independent contractor or proprietor to treat a share of his or her income as reasonable compensation that is ineligible for the deduction.

In the case of a partnership or S corporation, the amount of the pass-through entity deduction is determined at the individual partner or S corporation shareholder level. Partners and S corporation shareholders take into account their allocable shares the partnership’s or S corporation’s qualified business income and their allocable shares of the partnership’s or S corporation’s W-2 wages (based on the allocable share of wage expense) and unadjusted basis (based on the allocable share of depreciation).

The new deduction is determined separately for each qualified trade or business of the taxpayer. A taxpayer cannot apply the W-2 wages and unadjusted basis from one trade or business for purposes of determining the cap applicable to a different trade or business of the taxpayer. This makes guidance on meaning of separate trades or businesses very important.

Special rules apply for determining the pass-through entity deduction for cooperative dividends, qualified REIT dividends and qualified publicly traded partnership income.

A taxpayer does not need to itemize deductions to claim the new deduction. Similar to other individual tax provisions, the pass-through deduction is available only in tax years beginning before 2026.

Fund Manager Carried Interests

US Tax Reform’s revisions to the taxation of carried interests granted to fund managers were relatively mild despite heavy media focus on this issue.

For determining whether a gain arising on the disposal of an “**applicable partnership interest**” held by a fund manager is a “long-term capital gain” (and, therefore, taxable at a preferential rate), the TCJA increases the holding period requirement from one year to a three years. Similarly, a gain allocated to a partner in respect of an “applicable partnership interest” from the sale of partnership assets will not be treated as a “long-term capital gain” unless the partnership has held those assets for at least three years.

For these purposes, an “applicable partnership interest” is an interest in a partnership (including a limited liability company taxed as a partnership) transferred to a partner in connection with the performance of substantial services by the taxpayer in certain trades or businesses involving the raising or returning capital and investment in specified assets (i.e., very broadly, a carried interest). Partnership interests held by corporations and capital interests (i.e., interests a partner paid for or recognized taxable income on the receipt, or vesting, of) are not “applicable partnership interests.”

The changes to the carried interest rules raise several questions. One issue identified early on was whether these rules can be circumvented with the use of an S corporation. A literal reading of the statute suggested it could, but in the recent Notice 2018-18, the Treasury and the IRS make clear that in forthcoming regulations the break given to “corporations” with respect to carried interests will not be available to S corporations.

Partnership Losses and Partnership Income

US Tax Reform introduced limitations on the ability of non-corporate taxpayers to use losses attributable to a trade or business to offset other (non-trade or business) income. The limitation applies at the partner or S corporation shareholder level.

Disallowed losses can, however, be carried forward to following years and treated as “net operating loss carryovers” (NOL carryovers).

It is worth noting, however, that the TCJA also introduced a provision that restricts the use of NOL carryovers to reduce taxable income to no more than 80% of taxable income as determined before NOL carryovers.

This limitation has the potential to prevent taxpayers from applying substantial business losses (whether from partnerships or from their own direct business activities) to reduce the tax on their passive investment income (such as interest, dividends and allocable shares of other income from partnerships not engaged in a trade or business) and employee compensation income.

Like many of the provisions in the TCJA that primarily affect individuals, unless extended, these rules will not apply to taxable years beginning after 2025.

Disposition of Partnership Interests

Non-US persons who sell or exchange interests in a partnership that is engaged in a US trade or business will now be required to recognize ECI on the sale to the extent the partner would have realized ECI had the partnership sold all of its assets. This is a direct legislative rejection of a recent US Tax Court decision to the contrary.

If a portion of the gain on a disposition of a partnership interest is treated as ECI, the purchaser of the interest is required to withhold 10% of the amount realized on the disposition (typically, the purchase price of the interest) and remit it to the IRS. If the purchaser fails to withhold, the partnership is required to withhold. This rule applies to sales of interests in any US, or non-US, partnership engaged in a US trade or business.

US Tax Reform in Context

It is not possible to understand US Tax Reform fully in isolation. The breadth and complexity of US Tax Reform is so wide, and the global economy so interdependent, that the impact on both US and non-US investors with US interests and operations is multifaceted.

Some of the implications for non-US entities with activities and interests in the US have already been touched on, but it is worth emphasizing that US Tax Reform is viewed best in the context of global tax competition, reform and efforts to address abusive tax-avoidance (i.e., base-erosion and profit shifting) arrangements adopted by multinational entities.

This section summarizes some of the key issues multinationals should be considering as a direct result of US Tax Reform before touching on some more general points about how US Tax Reform has been received, and is being reacted to, by governments and international bodies around the world.

Non-US Entities

The package of provisions introduced by the TCJA, both domestic and international, will have potentially significant consequences for non-US entities with either investment interests or business activities in the US. The provisions having the greatest impact include:

• Corporate Income Tax Rate Reduction

The headline rate-reduction measures will:

- Affect the investment value of US corporations generally (subject to the level of an investee US corporation's leverage, capital expenditure profile and scope of foreign operations)
- Affect the level of taxation on non-US investors that realize:
 - US trade or business income (i.e., ECI), or
 - Gains from disposition of certain interests in US real estate

• International Measures

The investment value of US corporations will also be impacted by the international provisions, including, in particular:

- The introduction of the participation exemption (as part of the move to a modified territorial system)
- The GILTI provisions (that limit the availability of that participation exemption)
- The BEAT (that imposes a minimum tax by imposing a restriction on the deductibility of certain payments overseas)

• Capital Structures

Many non-US institutional investors use intermediary entities as investment vehicles, including US corporations that serve to “block” the ultimate non-US investor from US income tax payment and return filing obligations. To promote tax efficiency, these US blockers are often capitalized with a combination of debt and equity.

Non-US institutional investors should consider the impact of the various limitations of interest deductibility contained in the new legislation, as well as the implications of the rate reduction, to determine whether these structures need to be adapted to reflect those limitations and changes in rate. To complicate matters further, there is no protection from the changes for existing debt arrangements. This necessitates consideration of capital structures put in place prior to the enactment of the TCJA.

In short, the capital structures of US entities owned by non-US investors should be revisited both prospectively and to the extent possible retrospectively.

• Asset Valuation

US Tax Reform changes will affect the tax treatment and valuation of investment asset classes such as corporate equities and investments in real estate and private equity.

• Investment Funds

US Tax Reform changes the taxation of private investment funds and their managers with potential collateral effects on non-US institutional investors.

Non-US Governments

Global tax competition has grown significantly since the financial crisis. The breadth and depth of US Tax Reform means it will have a major impact on tax regimes around the world. In this climate, international disputes will inevitably be more common with some components of US Tax Reform potentially subject to challenge before international bodies (e.g., the WTO).

The way in which any particular government may respond, however, depends on a number of considerations. Four key questions are, perhaps, particularly worthy of consideration.

• Corporate Income Tax Rate

To what extent does a non-US tax regime in question have a corporate tax rate that now looks high by comparison?

Prior to the US changes, corporate tax rates in the 20%-25% bracket did not look completely out of kilter, given that the largest economy in the world had a (headline) 35% tax rate. Now, suddenly, those economies appear exposed. Australia, for example, still has a headline rate of 30%. Although Australia intends to reduce this to 25% by 2026/27, it may come under pressure to reduce its rate sooner than that.

In addition, countries like the UK, which has gradually reduced its corporation tax rate from 28% to 19% since 2010, and which will reduce the rate to 17% in 2020, now look less remarkable than they did in the recent past.

In all likelihood, there will continue to be some downward pressure on corporate tax rates across the globe; any jurisdiction that was looking to increase corporate tax rates (and there were not many) will find it difficult to do so. Taxpayers should keep in mind, however, that governments still need to generate the same or greater revenue. As a result, if corporate tax rates decline, countries will look for other ways to make up for the loss, such as imposing additional taxes, increasing the tax rates on their VAT and sales taxes, and limiting deductions and exemptions.

• Locating Jobs and Functions

To what extent will US businesses respond to US changes (including, in particular, GILTI and FDII) by either:

- Bringing jobs and functions back to the US, and/or
- Creating new jobs and functions in the US rather than in another jurisdiction?

Although that is clearly one of the primary drivers behind the policy changes, it is not at all clear whether US Tax Reform will have those effects.

The introduction of a territorial system has traditionally tended to result in *more* offshoring in other jurisdictions. Some features of GILTI, in particular, may actually incentivize US businesses to locate (or, at least fail to dissuade them from locating) more intangibles *outside* the US. It is equally unclear whether FDII will be enough to tilt the balance in favor of the US.

If, however, the response of a significant number of businesses is to move a significant number of jobs and/or functions to the US, then other jurisdictions may need to look to respond by creating a number of new or additional targeted incentives (including, for example, enhanced R&D credits and expanded patent boxes) to discourage repatriation. Moreover, if a jurisdiction considers that the battle has been lost, it may seek to impose a significant repatriation tax or other toll charge in response.

In this light, it is perhaps not entirely surprising that, in reaction to the increasingly protectionist approach of the US, the WTO, along with several European finance ministers, have expressed their displeasure with FDII. The WTO appears prepared to challenge any provision it believes is harmful to free trade. Developments in this area (characterized further by the imposition of import tariffs and “trade wars”) will need to be tracked closely and on a global level.

• Modified Territorial System

To what extent does the introduction of a modified territorial system in the US encourage more aggressive tax avoidance outside the US by US businesses?

If dividends received from overseas are exempt from US tax, any tax saving outside the US should be absolute (subject to US anti-avoidance provisions).

• Consequential Reform

To what extent does US Tax Reform provide an opportunity to jurisdictions to adapt their tax systems to provide a symbiotic relationship with the US tax regime?

Many jurisdictions, especially those with “tax haven” characteristics, are nervous about the potential impact of the OECD BEPS Project. Such jurisdictions are currently reassessing their standing and function in the international tax community.

Although some aspects of US Tax Reform carry some of the hallmarks of the BEPS principles, the relative complexity of US Tax Reform should provide opportunities for tax-haven jurisdictions to make themselves more attractive from a tax point of view to certain US businesses. That said, policymakers in those countries need to take extreme care to ensure they do not incur the wrath of the international tax community for indulging in “unfair tax competition.”



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