ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Non-U.S. Multinationals

November 14, 2017

On November 2, 2017, the much anticipated Tax Cuts & Jobs Act was introduced in the U.S. House of Representatives. The bill was amended several times before being approved by the House Ways & Means Committee on November 9.

On November 9, the U.S. Senate introduced its own version of the bill which, while having many similarities, is also significantly different (although the Senate's version is reflected only in a description, not legislative text).

This memorandum sets forth a few key observations about the proposed bills that may be relevant to non-U.S.-based multinational groups. It must be emphasized, however, that the House and Senate bills are likely to go through many additional changes before a single agreed-upon bill becomes law, if ever.

1. **Limits on Net Interest Expense Deductions**

— Both bills propose two separate limits on net interest expense deductions. In each bill, the "worst of" the two rules will apply.

— The proposals would apply to any debt outstanding on Jan. 1, 2018. There is no grandfathering.

— These rules, combined with the proposal to reduce the U.S. corporate tax rate to 20%, would diminish the incentive to allocate the maximum amount of debt to the U.S. in a multinational structure. The rules may increase the after-tax cost of financings by U.S. companies, and may make preferred equity financings more attractive than debt financings in some cases.

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— *First Rule. 30% Earnings Limit.* The first rule limits the deduction for ***net*** business interest expense to 30% of adjusted taxable income (similar to EBITDA in the House bill and EBIT in the Senate bill). Disallowed interest expense can be carried forward, for 5 years in the House bill and indefinitely in the Senate bill.

- This may raise the cost of financings for higher-leveraged companies, including capital intensive companies, recently acquired companies and companies in a growth mode funded by debt.
- It is consistent with similar changes in law that have been enacted recently by some of our trading partners (e.g., Germany, UK) as a result of the OECD Base Erosion and Profit Shifting (BEPS) project.
- The rule is expected to apply on a U.S. consolidated group-wide basis for domestic corporations. Partnerships are evaluated on a separate entity basis, with rules to avoid double counting and to allow "excess" adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.

— *Second Rule. Limit Based on Group-wide Leverage.* The other new rule is intended to limit the net interest expense deductions of companies that are overleveraged in the United States compared to the company's global operations. The net interest expense of U.S. borrowers would be capped at 110% of the U.S. share of the group's overall EBITDA (in the House bill) or the group's global leverage ratio (in the Senate bill).

- This rule is a blunt instrument. It may deny U.S. interest expense deductions if U.S. operations have higher leverage as a result of different capital needs for different types of business inside and outside the United States. The rule could also affect groups with low overall leverage, if that leverage is unevenly distributed between the group's U.S. and global operations – there is no de minimis exception. The House version of the provision may deny U.S. interest expense deductions even if the U.S. and global operations have similar leverage, because of differences in U.S. and non-U.S. interest rates.

2. **Base Erosion: Payments to Foreign Affiliates**

— Both the House and Senate bills impose tax on outbound payments from U.S. companies to foreign affiliates.

— The House bill includes a 20% excise tax on outbound payments from domestic corporations (and branches) to foreign affiliates (excluding certain securities, commodities and service transactions, as well as interest and certain other payments). The tax would apply starting in 2019.

- Taxpayers can elect to avoid the excise tax by instead treating these outbound payments as "effectively connected income" to the foreign recipient, which would be currently taxable in the United States with an 80% foreign tax credit offset allowed. The excise tax seems designed as a club to force taxpayers to make the effectively connected income election.
  - The election would allow the foreign recipient to be taxed at a rate of 20% of the net profits (based on the profitability for the group of the specific product line) and, potentially, a branch profits tax of 30% (as reduced by applicable tax treaties).
- The rule only applies to groups with aggregate outbound payments subject to the rule exceeding $100 million.
- This controversial proposal, which is intended to address transfer pricing concerns, subjects to U.S. taxation income that is generally viewed as attributable – economically and under international tax principles – to foreign tax jurisdictions. This may result in double taxation, and, if the election is made, may not be eligible for relief under treaties.

- The rule was somewhat of a surprise (although it is in some way a variation on the "Border Adjustment Tax" that was included in the Republicans' 2016 blueprint for tax reform).

— The Senate bill provides for a minimum tax of 10% on the amount by which deductible payments to foreign affiliates exceed taxable income (determined without taking into account credits (including foreign tax credits) other than the research and development credit, and certain other adjustments).

- The rule would apply to corporations (including S corporations) and REITs with at least $500 million in annual gross receipts and for which deductible payments to foreign affiliates represent at least 4% of total deductions. Foreign corporations and foreign REITs would be subject to the rule if their ECI meets the gross receipts test.
- The Senate rule does not explicitly exclude payments of interest or other payments in connection with financial transactions. It would, however, exclude cost of goods sold from the scope of deductible payments subject to the rule.

— The Senate bill would also disallow deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.

3. **Limits on Deductibility of Net Operating Losses (NOLs)**

— Carrybacks of NOLs would be repealed, while carryforwards would become indefinite (with an inflation adjustment, in the House bill). The carryback and carryforward rules would apply only to NOLs that arise in taxable years beginning *after* December 31, 2017.

— A U.S. company would be able to deduct NOLs only to the extent of 90% of the company's taxable income under the proposal, consistent with the rules under the existing AMT. Since this rule applies in the AMT context under current law this means that, in many cases, the effective tax rate for the use of NOL carryovers is not changing materially.

- The 90% restriction would apply to taxable years beginning after December 31, 2017.
  - Under the House bill (but not the Senate bill), unlike the repeal of NOL carrybacks discussed above, the 90% restriction would *not grandfather preexisting NOLs*. Consequently, companies with substantial existing losses to carryforward would still pay some federal income tax in future years.
- To the extent a U.S. affiliate has existing NOLs, this rule – together with the reduced 20% corporate tax rate – could significantly reduce the benefit of those NOLs.

4. **Changes to the CFC Attribution Rules Would Significantly Expand CFC Taxation**.

— Under current law, a CFC is a foreign corporation that is directly or indirectly controlled by 10% U.S. shareholders who collectively own more than 50% of the foreign corporation's equity. Attribution rules apply in determining who is a 10% shareholder for purposes of determining whether a foreign corporation is a CFC. However, "downwards attribution" from foreign persons to U.S. persons does not apply.

— Both bills would expand the attribution rules applicable for CFC purposes, allowing downwards attribution from foreign persons to U.S. persons. This could cause foreign corporations to be treated as CFCs in situations where significantly less than 50% of the foreign corporation's equity is directly or indirectly owned by U.S. shareholders, particularly where such foreign corporation is affiliated with (but not a subsidiary of) another U.S. corporation. As a result, U.S. shareholders that directly or indirectly own or invest in at least

10% of the equity of a foreign corporation that is not treated as a CFC under current law could become liable for tax on subpart F income.

— The Senate bill also expands the definition of a 10% U.S. shareholder to any U.S. person that owns 10% by value (as well as the current rule which looks to 10% of voting power).

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