CLEARY GOTTLIEB

ALERT MEMORANDUM

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

January 2, 2018

On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). Most of the TCJA's provisions take effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system. This memorandum sets forth a few key observations about the TCJA that may be relevant to U.S. multinational groups.

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1. **Key Benefits for U.S. Corporations**

— The TCJA lowers the U.S. corporate tax rate to 21%, with corresponding changes to the deduction for dividends received from U.S. corporations. The rate reduction is effective starting in 2018.

— The corporate alternative minimum tax is repealed.

— U.S. taxpayers may immediately deduct 100% of the cost of certain qualified property acquired and placed in service before January 1, 2023. Immediate expensing is also allowed for property acquired and placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it is phased out completely for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods).

- The short life of the rule would create an incentive to acquire assets eligible for immediate expensing within the next 5 to 9 years.
- "Qualified property" is, generally, depreciable tangible property (including used property), and does not include shares in corporations, real estate, or intangibles such as goodwill and intellectual property. It also does not include property that is leased rather than purchased.

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2. **Limit on Net Interest Expense Deductions**

— The TCJA imposes a new limit on net business interest expense deductions. The limitation applies to any debt outstanding on Jan. 1, 2018. There is no grandfathering.

— This rule, combined with the proposal to reduce the U.S. corporate tax rate to 21%, will diminish the incentive to allocate the maximum amount of debt to the U.S. in a multinational structure. The rule 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.

— The rule limits the deduction for net business interest expense to 30% of adjusted taxable income. "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.

- 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.
- Particularly in 2022 and later years, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions, due to the change from EBITDA to EBIT. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect, and therefore U.S. borrowers should take into account the switch to EBIT in considering their current debt profile.
  - Additionally, this change may encourage acquisitions of tangible assets eligible for 100% expensing (described above) in taxable years before 2022, to accelerate depreciation deductions into earlier years and increase capacity for interest expense deductions in 2022 and later years.
- 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 allow "excess" adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.

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

— Under the TCJA, carrybacks of NOLs are no longer allowed, while carryforwards become indefinite. The carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.

— A company may use NOLs to offset a maximum of 80% of the company's taxable income for taxable years beginning after December 31, 2017 (with unused NOLs carried forward into future years).

— To the extent you have existing NOLs, the reduced 21% corporate tax rate could significantly reduce the benefit of those NOLs, and therefore reduce the value of your deferred tax assets.

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

— The TCJA imposes a minimum tax (called the "BEAT") on a U.S. corporation's taxable income after adding back certain "base erosion payments."

— Base erosion payments are deductible payments from domestic corporations and branches to foreign affiliates, excluding cost of goods sold (except for corporations that expatriate from the U.S. after November 9, 2017), certain payments for services, and certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers). Deductible payments are also excluded to the extent they are subject to U.S. withholding tax.

- There are no exclusions for interest or other payments in connection with financial transactions other than derivatives. Moreover, there is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in "Limits on Net Interest Expense Deductions" above as paid to unrelated parties for purposes of the minimum tax, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the minimum tax.

— The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back base erosion payments over (b) the corporation's tax liability at the regular corporate rate.

- The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years.
- Increased rates apply to U.S. banks and registered securities dealers: 6% in 2018, 11% in 2019 through 2025 and 13.5% in 2026 and later years. However, the base erosion tax does not apply to most payments in connection with derivatives which are marked to market.
- In calculating tax liability at the regular corporate rate, certain credits are not taken into account, with the effect that the credits can mitigate the amount of minimum tax paid. In 2018 through 2025, 80% of low-income housing and energy credits are excluded, and in 2026 and later years, all credits are excluded.

— The minimum tax applies to corporations with at least $500 million in annual gross receipts and for which base erosion payments represent at least 3% of total deductions (2% for U.S. banks and securities dealers). Foreign corporations are subject to the rule if their ECI meets the gross receipts and 3%/2% tests.

— The TCJA also disallows deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.

5. **Base Erosion – Low-Taxed Intangibles Income**.

— Under the TCJA, a U.S. shareholder's income includes a new category of "global intangible low-taxed income" taxed to individual shareholders at 100% of the applicable rate; and taxed to corporate shareholders at 50% of the usual rate (*i.e.*, a 10.5% rate) through 2025, and at 62.5% of the usual rate (*i.e.*, a 13.125% rate) in 2026 and later years.

— This rule most likely is intended to capture CFCs that earn high returns on assets consisting of intangibles, that have assets that are not depreciable or have already been significantly depreciated, or that have a business (*e.g.* sales or services) that does not require tangible assets.

— 80% of foreign taxes attributable to this low-taxed intangibles income is creditable by corporate shareholders (subject to some limitations), but not by individuals. As a result, a CFC would need to pay tax at an effective rate of 13.125% (through 2025) or 16.41% (in 2026 and later years) in order to avoid triggering tax under this rule.

— The TCJA also includes a special 13.125% tax rate (increased to 16.41% in 2026 and later years) for a domestic corporation's "foreign-derived intangible income," which is income related to services provided and goods sold by the domestic corporation for a foreign use, and is calculated in a similar manner as "global

intangible low-taxed income." This rule may encourage bringing some offshore intangible assets back to the United States.

6. **Shift to a Territorial System**. The TCJA adopts a territorial system of international taxation, effective January 1, 2018. It will likely result in the repatriation of significant amounts of offshore cash to U.S. corporates.

— A one-time transition tax will be imposed on the earnings of foreign subsidiaries. The earnings will be taxed at rates of 8% and 15.5% for corporate shareholders (for earnings invested in tangible assets vs. cash), and 9.05% and 17.54% for investors taxed as individuals and subject to the highest marginal rate. These rules will effectively "unlock" the trapped cash held offshore by U.S. multinationals. Taxpayers can generally elect to pay the tax over 8 years, although there are triggers to accelerate the payment (*e.g.*, sale of all or substantially all of the assets of a taxpayer). There are rules permitting earnings deficits to offset undistributed earnings amounts.

— Under the new system, the dividends received by a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries are generally exempt from tax (if attributable to foreign source income).

- This participation exemption is intended to make U.S.-parented companies more competitive internationally, and to encourage these companies to bring offshore cash back into the U.S. It will make managing a U.S. corporation's foreign tax position even more important than it has been to date.
- Dividends exempted from tax reduce the U.S. corporation's basis in the foreign subsidiary, reducing the U.S. corporation's ability to claim losses on a future sale of the subsidiary.
- The participation exemption does not apply to foreign corporations that are passive foreign investment companies.
- The exemption is available only to U.S. corporate shareholders who have held foreign subsidiary stock for at least 1 year (subject to potential tolling rules).

— This is not a full participation exemption. Dividends received by non-corporate taxpayers as well as dividends from subsidiaries in which the U.S. taxpayer does not own 10% of the equity (by vote or by value) will be fully taxable (with potential for foreign tax credit relief). The exemption does not apply to gains from the sale of shares (although gains recharacterized as dividends under section 1248 would be exempt). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

— A domestic S corporation which owns 10% or more of the stock of the foreign corporation appears to be eligible for the participation exemption, in which case large individual shareholders (or groups of individual shareholders) may benefit from transferring the stock in a foreign corporation they own into an S corporation. There are additional consequences to owning an interest in an S corporation that individual shareholders should consider before undertaking such a transfer.

— Despite the exemption for actual dividends from foreign subsidiaries, the TCJA retains the existing rule (section 956) that requires a U.S. shareholder of a CFC to currently include in income the earnings of the CFC reinvested in United States property. Loans from CFCs to U.S. corporate shareholders, pledges of CFC stock to support borrowings of U.S. corporate shareholders, and other investments by CFCs in U.S. property (including owning stock of U.S. affiliates and other U.S. tangible and intangible property) will continue to give rise to deemed dividend inclusions that are fully taxable.

7. **Deferred Compensation**. The TCJA generally leaves intact the current regime for deferred compensation (though previous drafts of the TCJA included very significant changes). However:

— The TCJA includes a new deferral provision for certain types of broad-based employee equity, which may apply to certain private companies.

— The TCJA expands the group of covered employees that are subject to the $1 million cap on deductible compensation to include the CFO as well as the CEO, and repeal the exception from this rule for performance-based compensation. The TCJA grandfathers compensation vested prior to 2017 under existing contracts.

8. **Timing Issues**. The TCJA requires most accrual-method taxpayers to take items of income into account for tax purposes no later than the time it is included on the taxpayer's audited financial statements or annual reports, subject to certain exceptions (including an exception for mortgage servicing contracts). The rule generally takes effect beginning in 2018, but is delayed until 2019 for debt instruments with original issue discount.

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