Tax Reform for Business Lawyers – One Year Later

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Panelists: Brian Harvel, Alston & Bird LLP
Michael Kliegmann, Akin Gump
Roger Royse, Royse Law Firm PC
William Hays Weissman, Littler
Case Study

1. Investor A wants to acquire “SpeedFast”, a US based multinational group of companies
2. The SpeedFast develops, manufactures and distributes high quality gear shifters and other equipment for bikes
3. The group also holds several patents for their invention “ultra gear shift maximum”, a super smooth gear shift with a patented technology that is exclusively used by the US racing team
4. This and other patents were developed by the European R&D Center but are by the US distributor
5. The European service company also provides technology services to the US manufacturer
6. To fund all its activities, the group also obtained loans from a US bank.
Investor A wants to acquire a US Co. The US Co has two subsidiaries: a US Distributor and a Foreign Distributor. The US Distributor has a contract with a US Manufacturer for technology services rendered to the US Manufacturer. The Foreign Distributor has a contract with a Foreign R&D, Service and Manufacturer. The Foreign R&D, Service and Manufacturer has a contract with a Foreign Finance Co. The bank in the diagram represents a financing arrangement or transaction between the parties.
Investor A wants to acquire

US Co

US Distributor

US Manufacturer

Foreign Distributor

Foreign R&D, Service and Manufacturer

Foreign Finance Co

$ for goods manufactured and R&D services

$ royalties for IP
Investor A wants to acquire a US Co, which distributes products in the US. The US Co has a foreign distributor. The US Co borrows from a foreign bank, and interest is paid to the foreign bank. Investor A is interested in acquiring the US Co. The US Co has a US manufacturer and a foreign R&D service and manufacturer. The foreign R&D service and manufacturer is part of a foreign finance co.
Case Study

Investor A wants to acquire...

- US Co
  - US Distributor
  - US Manufacturer
  - Foreign Manufacturer
    - Foreign R&D, Service and Manufacturer
    - Foreign Finance Co

- Interest paid on loan granted by Foreign FinCo to US Co
- Interest paid for goods manufactured and R&D services
- Royalties for IP
- Interest
- For technology services rendered to US Manufacturer
Questions to consider

1. How should Investor A acquire the group?
   a) Should A buy it personally or through an acquisition vehicle?
   b) If the latter, what form should this vehicle have?
   c) Should he acquire US Co or the distributors with their subsidiaries?
2. Does the group have a BEAT exposure?
3. Does US Co have a GILTI problem?
4. Is the group subject to interest limitations?
CHOICE OF ENTITY
Choice of entity

1. What are the advantages/disadvantages of purchasing the group as an individual?
2. What should A consider when choosing an entity form?
3. Should A think about utilizing opportunity zones?
INTEREST DEDUCTIBILITY UNDER 163(J)
Case Study

Investor A wants to acquire US Co, which distributes products in the US market. The US Co is financed by Foreign FinCo, which charges interest on the loan. The Foreign FinCo is owned by Foreign Co, which provides service and manufacturing capacity. The US Manufacturer is foreign-owned, providing R&D and manufacturing services to US Co. The Foreign Co provides foreign finance to US Co, with interest paid on the loan.
Interest Expense Limitation - Overview

### Before Tax Reform
- Denial of deduction for interest paid to a related party if no U.S. tax was imposed on the corresponding interest income.
- Limitation did not apply if debt equity ratio of 1.5 was met or net interest expense was <50% of adjusted taxable income.

### After Tax Reform
- **New Interest Expense Limitations**: Limited to the sum of (i) business interest income plus (ii) 30% of adjusted taxable income, which generally corresponds to earnings before interest, taxes, depreciation and amortization (EBITDA) for tax years beginning before January 1, 2022, and earnings before interest and taxes (EBIT) thereafter
- **Carryforward Availability**: Indefinitely, potential limitations in case of an ownership change
- **Applicability**: All taxpayers except for small businesses and to all indebtedness
  - All (related and third party) debt is subject to the limitation
  - New and pre-existing debt is subject to the limitation (i.e., there is no grandfathering)

Interest expense limitation now in-line with many OECD countries.
Interest Limitation Expense – Observations & Limitations

• Generally in line with OECD recommendations
• The transition to EBIT in 2022 will likely mean a harsh result for many taxpayers
• Exceptions for certain real estate businesses, regulated public utilities, auto dealerships, and small businesses
• Disincentivizes highly-leveraged transactions and increases the attractiveness of equity funding (including preferred equity)
• Historically low interest rates in U.S. vs. increasing interest rates
• Lower 21% corporate income tax rate makes it less costly to lose a deduction than with the former 35% rate

No grandfathering on pre-existing debt
Case Study

Investor A wants to acquire US Co, a US manufacturer for technology services rendered to US Manufacturer.

- **US Co**
  - **US Distributor**
    - **US Manufacturer**
      - Royalties for IP
    - **Foreign R&D, Service and Manufacturer**
      - for goods manufactured and R&D services
  - **Foreign Distributor**
    - Foreign R&D, Service and Manufacturer
    - Foreign Finance Co

$ for technology services rendered to US Manufacturer

Interest paid on loan granted by Foreign FinCo to US Co
## BEAT - Overview

### Before Tax Reform
- Related party payments fully deductible so long as arm's length
- Potential ability to minimize U.S. taxable income using intercompany deductions

### After Tax Reform
- **Alternative minimum tax** on certain U.S. corporation's income adjusted for "base erosion payments." BEAT rate is 5% in 2018, 10% in 2019, and 12.5% starting in 2026

### Diagram:
- **Base erosion payments** = deductible payments made to foreign affiliates (e.g., service fees, interest, royalties, depreciation deduction of property acquired from foreign affiliates)

### Base erosion payments exclude:
- Payments that reduce gross receipts, such as cost of goods sold (COGS),
- Payments that are subject to withholding taxes under a treaty (to the extent subject to withholding), and
- Payments for low-margin services.
BEAT – Observations & Implications

• No exceptions for:
  • payments made pursuant to APAs and other agreements, payments that are U.S. ECI, and payments subject to high rates of foreign taxation

• Double taxation on:
  • payments to CFCs [GILTI and also subject to BEAT]

• No foreign tax credits allowed when calculating BEAT

• Taxpayer may receive full, or no, benefit from base eroding payments depending solely on the amount of residual regular tax liability in the US

• Interplay between Capital Investment Expense Deduction & BEAT: immediate expensing may increase current year BEAT exposure

BEAT applies to U.S. corporations:

• with $500 million + average annual gross receipts over last 3 taxable years, and
• a "base erosion percentage" of 3%[1] or more in a tax year

Note [1]: 2% for banks and registered securities dealers
# BEAT Example

<table>
<thead>
<tr>
<th>Regular Tax Liability</th>
<th>BEAT Tax Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Before Base Erosion Deductions</td>
<td>Regular Taxable Income $210</td>
</tr>
<tr>
<td>Base Erosion Payments</td>
<td>Disallowed NOLs (added-back)</td>
</tr>
<tr>
<td></td>
<td><em>(assumes a Base Erosion % of 33%)&lt;sup&gt;1&lt;/sup&gt;</em></td>
</tr>
<tr>
<td>Taxable Income Before NOL Deduction</td>
<td>Base Erosion Payments (added-back) $330</td>
</tr>
<tr>
<td>NOL Deduction</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Modified Taxable Income $570</td>
</tr>
<tr>
<td>Regular Taxable Income</td>
<td>Applicable Beat Rate 10%</td>
</tr>
<tr>
<td>2019 CIT Rate</td>
<td>Tax Before Credits $57</td>
</tr>
<tr>
<td>Tax Liability Before Credits</td>
<td>FTCs</td>
</tr>
<tr>
<td></td>
<td>80% of General Business Credits ($6)</td>
</tr>
<tr>
<td>FTCs</td>
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<tr>
<td>General Business Credits</td>
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<tr>
<td>Regular Tax Liability</td>
<td>Tax Liability with BEAT $51</td>
</tr>
</tbody>
</table>

**Base Erosion Minimum Tax (i.e., incremental tax) = $38.40** ($51-$12.6)
Case Study

Investor A wants to acquire

- US Distributor
- Foreign Distributor

- US Manufacturer
- Foreign R&D, Service and Manufacturer
- Foreign Co

BANK

royalties for IP
FDII - Overview

<table>
<thead>
<tr>
<th>Before Tax Reform</th>
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<th>After Tax Reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>u.s. tax on intangible income of U.s. corporation subject to full statutory rate</td>
<td>FDI is an approximation of U.S. corporation's taxable income from exploiting intangible property outside the U.S. and is taxed at the beneficial effective tax rate of 13.125% (increases to 16.406% starting in 2026)</td>
<td>Achieved through a special deduction for 37.5% of U.S. corporation's FDII – leading to an effective tax rate on FDII of 13.125%</td>
</tr>
<tr>
<td>incent to shift intangibles to low tax jurisdictions to reduce global effective tax rate</td>
<td></td>
<td>Property does not need to be manufactured in the US to benefit from FDII</td>
</tr>
</tbody>
</table>

Favorable U.S. tax regime for U.S. corporation's intangible income derived from serving foreign markets

FDII = All the U.S. corporation's income derived from foreign sales, royalties, or services less a deemed return (10%) on its tangible assets

![Diagram](attachment:image.png)
Limitations on Income shifting Through Intangible Property Transfers

- **Potential incentive** for U.S. corporations to locate investment offshore
- **Foreign owned U.S. branches** ineligible for the preferential FDII rate, notwithstanding its being subject to full U.S. taxation
- **Non-U.S. reactions?** Germany may deny deduction for royalty payments to U.S. persons that qualify for FDII benefits. Other possible issues – Australia? Netherlands?
- **WTO reaction** to be determined
- **On-shoring of existing IP** by U.S. companies?

- Congress's motivation behind FDII was to prevent U.S. companies from offshoring U.S. IP, rather than bringing them back into the country, a Treasury official said
- The intent of FDII was to neutralize the tax advantage for IP held offshore with IP held onshore

Similar to GILTI, the phrase "intangible income" is misleading because FDII is broader than just intangible income. The formula assumes a fixed rate of return on business assets (10%) and the residual income is the income deemed to be generated by the IP

Great incentive for U.S. corporations in the service or technology industry or any other industry that does not have significant amounts of fixed assets
Case Study

Investor A wants to acquire...

- Interest paid on loan granted by Foreign FinCo to US Co
- US Co
  - US Distributor
    - US Manufacturer
      - Royalties for IP
        - US Co
          - Foreign Distributor
            - Foreign R&D, Service and Manufacturer
              - Foreign Finance Co
                - Interest paid on loan granted by Foreign FinCo to US Co
                  - Interest
                    - For goods manufactured and R&D services
                      - For technology services rendered to US Manufacturer
# GILTI - Overview

<table>
<thead>
<tr>
<th><strong>Before Tax Reform</strong></th>
<th><strong>After Tax Reform</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. tax on income of Controlled Foreign Corporations (&quot;CFC&quot;) deferred until repatriation (if ever) <strong>unless</strong> the income was of a type subject to subpart F and taxed currently</td>
<td>U.S. shareholder is subject to current <strong>effective tax rate of 10.5%</strong> on all of CFC's income (e.g., IP Hub) (<strong>increases to 13.125% starting in 2026</strong>)</td>
</tr>
<tr>
<td>Cash would accumulate in low-tax jurisdiction</td>
<td>Foreign tax credit offset of 80% is permitted – leading to approximately <strong>13.125% ETR</strong> for the tested income (increases to 16.406% starting in 2026)</td>
</tr>
</tbody>
</table>

**GILTI income** = All of CFC's income (not otherwise subject to U.S. tax under other U.S. regimes, such as subpart F and ECI) less a deemed return (10%) on the CFC's tangible assets if it is not subject to a minimum foreign tax rate (e.g., 13.125)

Anti-base erosion measure for U.S. taxpayers that own 10% or more of a CFC

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![Diagram](image.png)
Potential incentive for U.S. corporations to locate investment offshore, because:

- under GILTI, deemed return on tangible property owned by a CFC (outside of the US) reduces the GILTI inclusion (reducing the amount of non-U.S. income subject to U.S. tax)
- under FDII, the deemed return on tangible property owned by the U.S. corporation (located in the US) reduces the amount of income subject to lower favorable tax rates

Global low-taxed "intangible income" is misleading because GILTI tax applies much more broadly than just to intangible income. It applies to all of a CFC's income less a deemed return (of 10%) on the CFC's tangible depreciable assets (e.g., buildings)

Accordingly, the GILTI tax can apply to many non-U.S. companies that do not have significant tangible assets, such as investment management, consulting, accounting, financial advisory, engineering, distributors, and IP-rich businesses
Employment tax considerations

• Stock versus asset purchases
• Who will remain the employer
• Successor issues
• Transfer of payroll information to purchaser
This presentation will focus on the 2017 Tax Reform, also known as the Tax Cuts and Jobs Act ("TCJA"), and issues business lawyers should be aware of when structuring acquisitions.

The TCJA introduced new aspects to entity choices when setting up an acquisition structure. Whether an acquisition is structured through an individual, an S-Corp or a partnership has big implications on the taxation. The TCJA brought many changes to the pass through taxation and the use of subchapter S corporations.

The tax reform also changed the thinking of how to finance an acquisition. In the past, within the limitation of re-characterization of debt into equity, in many instance debt was the financing option that was preferred over equity financing. However, the TCJA forces US companies to rethink this approach. Under the new law, financing the purchase through debt can be particularly challenging given the new limitation on interest deductibility. Based on the amended provisions of the Internal Revenue Code, interest expenses may only be deducted up to the net interest income plus 30% of the adjusted taxable income, which is basically the same as EBITDA. As of 2021, this limit will be further tightened by replacing the EBITDA limit with 30% of EBIT. Any interest that was not deductible in any given year, may be carried forward and utilized in later years. The limitation applies to debt by related and unrelated parties alike and generally makes additional modelling necessary. While this limitation of the interest deductibility is a tax provision many countries have implemented recently and which the European Union forced on their Member States by way of Directive, most other countries draw a distinction between unrelated party debt, which is not subject to the limitation and related party debt, which is subject to the new rules. The US law does not differentiate, which makes finding the most beneficial financing structure quite an exercise.

Once the acquisition structure has been set up and the purchase has been accomplished, other provisions of the TCJA have to be considered. The new law brought many changes to the taxation of the US based group, especially where foreign subsidiaries are involved. The implementation of BEAT, the Base Erosion Anti Abuse Tax, has left many US multinationals scratching their head searching for operational structures avoiding this levy. Though only applicable to large companies, BEAT results in a minimum taxation of the US entity by disallowing certain payments made to related parties abroad. Specifically service industries are impacted by this levy the most. Unlike for payments made for costs of goods sold, which are not taken into account for purposes of calculating the BEAT levy, payments made by a service company for services received from a related foreign party are taken into account. This means that through a complex calculation, these payments made to foreign related party service providers are added back to the taxable income, which - in effect - results in denying their deductibility, and the final BEAT obligation is calculated. The limitation of the use of foreign tax credits and general business tax credits adds to the complexity of this new tax. While BEAT is only payable if the tax payable under BEAT exceeds the regular income tax liability and thus, functions as some kind of minimum tax, the specific rules are so broad that many large US multinationals will likely be impacted by this tax.

Lastly, the TJCA also introduced the GILTI tax, the Global Intangible Low Taxed Income tax, which in effect expands the Subpart F regime. Under the GILTI regime, income derived by foreign subsidiaries minus a routine return may be subjected to US income taxation if it is subject to a low taxation abroad. Any income that is already subject to Subpart F taxation will not be included, which shows that GILTI is designed to sweep up most of the income that is not yet subject to Subpart F. Additionally, GILTI also introduced comprehensive provisions dealing with the foreign tax credits available to the US company. Under certain circumstances these foreign tax credit rules may make it beneficial to affirmatively plan into Subpart F income. A result that is one of the interesting results from the TCJA.

The panel will discuss these new provisions including the choice of entity question based on a case study that resembles a real life acquisition scenario. The discussion will focus on the US tax consequences as well as employment tax issues typically triggered by an acquisition and special consideration will be given to how the TCJA has changed the decision making process.