Puzzled by U.S. Tax Reform?

On December 22, 2017, President Trump signed broad tax reform legislation into law that will have significant implications to U.S. investments. But what does it really mean for foreign multinational entities with existing U.S. operations or for those exploring opportunities in the U.S. market?

1. FEDERAL TAXATION OF U.S. OPERATIONS

Among some of the changes are a reduction of the corporate tax rate to 21 percent, elimination of net operation loss ("NOL") carrybacks replaced by a generous indefinite carryforward period, and a general limitation on NOL deductions of 80 percent of adjusted taxable income. In addition, the corporate alternative minimum tax, which added much complexity to the Internal Revenue Code ("IRC"), has been eliminated. The domestic production activities deduction has been repealed. New rules permitting 100-percent bonus depreciation and capital expensing provide large benefits for those making domestic capital investments.

2. STATE TAX CONSEQUENCES

Tax reform creates additional tax complexities for foreign investment in the United States from a state tax perspective. Not all states follow the IRC in the same manner and how a state adopts the impending changes will impact a state's taxable income computation. Some states will need to pass additional legislation in 2018 if they wish to adopt the federal rules, or conversely, to prevent the rules from taking effect. C corporations will continue to benefit from the state and local tax deductions that have been repealed with respect to other taxpayers.

3. CROSS-BORDER PAYMENTS

Tax reform adds new rules impacting certain corporations that make cross-border payments to related foreign parties. If certain threshold conditions are satisfied, one such measure imposes a Base Erosion and Anti-Abuse Tax ("BEAT") as a minimum tax on certain U.S. corporations and foreign corporations with U.S. branches that take U.S. tax deductions giving rise to "base erosion tax benefits." In addition, tax reform generally limits certain interest expense deductions to 30 percent of modified adjustable taxable income, including certain cross border interest payments.

4. ANTI-HYBRID RULES

Tax reform adds a new rule which may disallow deductions for interest and royalties paid or accrued to a related party pursuant to a hybrid transaction or by, or to, a hybrid entity in certain situations. This rule bears some resemblance to the Organization for Economic Co-operation and Development proposals in BEPS Action 2 applicable to hybrid instruments and hybrid entities.

5. CONTROLLED FOREIGN CORPORATIONS

Tax reform modifies certain constructive stock attribution rules used to determine whether a foreign corporation is treated as a controlled foreign corporation ("CFC") for U.S. tax purposes. As a result, stock of a foreign corporation owned by a foreign shareholder of a U.S. corporation may be attributed to a U.S. subsidiary of that foreign shareholder for purposes of determining whether such a foreign corporation is a CFC and whether the U.S. subsidiary is a U.S. shareholder in the foreign corporation. This will increase the number of foreign corporations treated as CFCs. U.S. shareholders of CFCs are generally required to file certain information returns to report their ownership interests in the CFCs along with certain other information. The IRS recently provided guidance in Notice 2018-13 on information reporting for certain foreign corporations that are CFCs due to the modification in constructive stock attribution rules.

6. INTANGIBLES

Tax reform provides U.S. corporations with a reduced tax rate on foreign-derived intangible income ("FDII"). Further, U.S. shareholders of CFCs must now include their portion of global intangible low-taxed income ("GILTI") of such CFCs into taxable income. In many cases, a detailed review of a group's ownership of intangibles and business model will be needed. While GILTI and FDII generally target intangible income, given the broad scope of these provisions, multinational groups should review their structures and supply chains to determine the implications to these new rules even in situations where they do not otherwise generate income from intangible property.

7. PARTNERSHIP INTERESTS

The tax reform provisions provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor partner (as opposed to the partnership) would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. In addition, the purchaser/transferee is generally required to withhold under new withholding tax rules that apply in these instances.

TAX REFORM WILL HAVE PROFOUND EFFECTS ON THE WAY FOREIGN ENTITIES WITH A U.S. FOOTPRINT ARE STRUCTURED.

The federal tax changes will have an impact on the tax planning for foreign investment and it will be necessary to model these changes to understand how to best position U.S. operations going forward.

Foreign entities also have to understand and layer on how tax reform will impact their cost of doing business in the United States from a state tax perspective.

The new rules that apply to cross-border payments may require foreign entities with U.S. investments to re-examine their related party arrangements, capital investment and financing structures for existing or future U.S. operations.

As a result of new anti-hybrid rules, foreign entities will need to understand the local characterization of royalty and interest payments among related parties and may need assistance as this is not always easy to determine.

Changes to the CFC attribution rules may result in an increased compliance burden to the U.S. members of foreign multinational groups in certain situations.

As always, foreign entities with U.S. operations should not undertake any radical action or restructuring of their businesses without careful consideration of all implications, for both the U.S. and other territories.

For more information on the international impacts of U.S. tax reform, visit bdo.com/tax-reform.

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