2017 TAX CUTS & JOBS ACT: WHAT YOU SHOULD KNOW

BUSINESS & INTERNATIONAL TAX REFORM

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2017 TAX CUTS & JOBS ACT: WHAT YOU SHOULD KNOW SESSION 2

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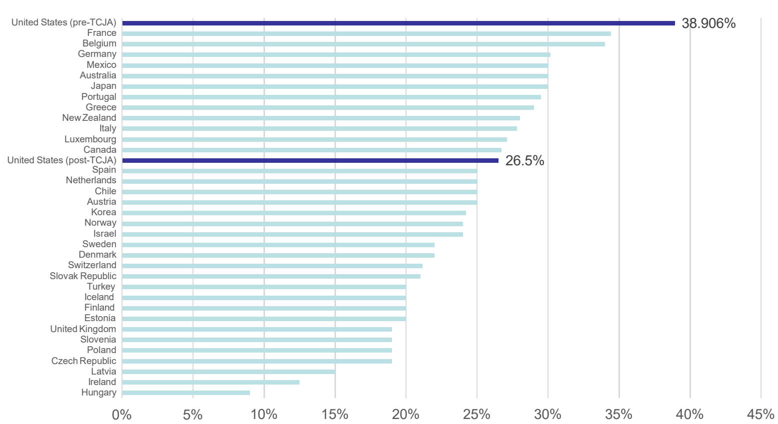
Introduction

- Pub. L. No. 115-97 (commonly known as the Tax Cuts and Jobs Act of 2017 or "TCJA") signed into law on December 22, 2017
- Session 1 – February 6
  - Individual tax reform
- Session 2
  - Corporate tax rate cut and deductions
  - Economic and budget effects
  - Section 199A deduction
  - Choice of entity
  - Executive compensation and employee benefits
  - U.S. international tax

Corporate Income Tax Rate

- **Corporate Rate Reduction**
  - **Corporate tax rate reduced to flat 21 percent rate for tax years beginning after December 31, 2017**
  - **No expiration**
- **Corporate Alternative Minimum Tax Repealed**
  - **Alternative minimum tax credit is refundable**

OECD Corporate Income Tax Rates



Post-TCJA corporate tax rate assumes a blended 5.5% state and local tax rate.

Dividends Received and NOL Deductions

- Reduction in Dividends Received Deduction
  - 70% dividends-received deduction reduced to 50%
  - 80% dividends-received deduction reduced to 65%
  - 100% dividends-received deduction for dividends from corporations owned 80% or more remains intact
- Use of NOLs generated in 2018 or after limited
  - Amount of NOL deduction limited to 80% of taxable income, calculated without regard to the NOL deduction
  - Carryback eliminated
  - Carryforward made indefinite

Limitation on Business Interest Deduction

- Under Section 163(j), deduction of business interest is generally limited to the sum of:
  - Business interest income, and
  - 30% of adjusted taxable income
- "Business interest" and "business interest income" defined as interest or income allocable to a trade or business
- Disallowed interest carries forward

Limitation on Business Interest Deduction

- For partnerships, the business interest deductibility limitation applies at the partnership level.
  - If a partnership's business interest is disallowed as a deduction, complex rules govern allocations of disallowed business interest to partners.
- Exemption from business interest deductibility limitation for small businesses
- Other businesses excluded from application of Section 163(j) under definition of "trade or business"
  - Electing farming business
  - Electing real property trade or business
  - Certain regulated utilities

Bonus Depreciation

- Extension of Section 168 bonus depreciation
  - 100% depreciation deduction for qualified property placed into service after September 27, 2017 and before January 1, 2023
  - Thereafter, annual phase down in bonus depreciation percentage
- Expansion in definition of qualified property
  - Now includes used property

Section 179 Expensing

- **Amount that taxpayer may expense and phaseout threshold increased**
  - **Maximum Section 179 expensing increased to $1 million**
  - **Phaseout threshold increased to $2.5 million**
  - **Indexed to inflation**
- **Definition of qualified property expanded**
  - **Qualified improvement property and certain improvements made to nonresidential real property**

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Economic and Budget Effects

- Nonpartisan Joint Committee on Taxation predicts that relative to prior law, the TCJA will reduce federal tax revenue by $1.456 trillion over the next ten years
- JCT predicts that this will be partially offset by an approximate .7% increase in GDP, on average, over the next ten years, which will increase tax revenues
- Some of the benefit of the increased tax revenues will be lost by increased interest payments resulting from increases in federal debt and rising interest rates
- Taking all of this into account, the JCT estimates that on a net basis, the TCJA will reduce revenues by $1.071 trillion.

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Economic and Budget Effects

Table 1. Estimated Budget Effects of the Conference Agreement for H.R. 1

Billions of Dollars

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-2027
Individual	-75.3	-188.8	-171.9	-156.3	-150.8	-144.0	-140.9	-139.2	-41.4	83.0	-1,126.6
Business	-129.3	-133.8	-112.9	-92.5	-50.4	-16.4	-15.9	-24.1	-28.4	-49.4	-653.8
International	68.9	42.6	26.0	28.0	22.9	22.5	36.7	48.7	29.1	-0.8	324.4
Total	-135.7	-280.0	-258.8	-220.8	-178.3	-137.9	-120.1	-114.6	-40.6	32.9	-1,456.0

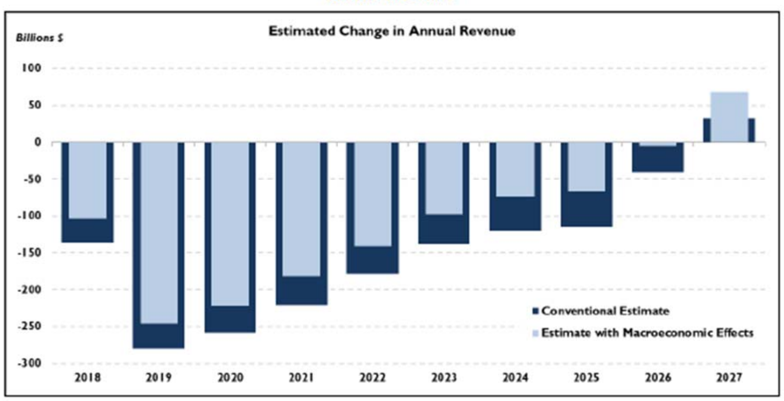
Source: Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1*, https://www.jct.gov/publications.html?func=startdown&id=5053.

Notes: Rows and columns may not sum due to rounding.

Economic and Budget Effects

Figure 1. Estimated Budget Effects of the Conference Agreement for H.R. 1: Conventional and Macroeconomic Analysis

Billions of Dollars



Source: CRS analysis of Joint Committee on Taxation, *Macroeconomic Analysis Of The Conference Agreement For H.R. 1, The "Tax Cuts And Jobs Act"*, committee print, 115th Cong., 1st sess., December 18, 2017, JCX-69-17.

Economic and Budget Effects

- **TCJA is expected to reduce taxes for the 500 largest U.S. companies by between $75 billion and $100 billion in 2018**
- **Expected to affect small cap companies more than large cap.**
  - Median effective tax rate for companies in Russell 2000 = 31.9%
  - Median effective tax rate for companies in S&P 500 = 28%
- **What will companies do with the extra money from tax cuts, as well as repatriated funds?**
  - Bonuses, raises, or increased 401(k) contributions
  - Capital expenditures
  - Dividends
  - Stock buy-backs
  - Debt reduction
  - M&A

Section 199A Deduction

- **Myth #1: Applies only to income from partnerships and S corporations**
- **Myth #2: Not available to taxpayers in service businesses**
- **Myth #3: No value to high income taxpayers**

Section 199A Deduction

- New deduction of 20% of qualified business income under new Section 199A
  - Available to non-corporate taxpayers
  - QBI: "ordinary" income -- less ordinary deductions -- you earn from a sole-proprietorship, S corporation, or partnership
    - Does not include wages, guaranteed payments, or capital gains
  - For individuals who will now pay tax at the new top marginal rate of 37%, the deduction generally results in a top 29.6% tax rate on QBI
  - Deduction limited to 20% of taxable income less net capital gains

Section 199A Deduction

- Example #1: Tom is a 50% partner in a restaurant. Tom's qualified business income from the partnership for 2018 is $260K. Tom and his spouse file a joint return and report $300K of taxable income and no capital gains
- Deduction is equal to the lesser of 20% of QBI or 20% of taxable income
  - 20% of $260K = $52K < 20% of $300K = $60K → Section 199A deduction = $52K
- What if taxable income is $200K?
  - 20% of $260K = $52K < 20% of $200K = $40K → Section 199A deduction = $40K

Section 199A Deduction

- **Wage limitation phased-in for taxpayers with taxable income in excess of threshold**

	No Wage Limit	Wage Limit Phase-In	Full Wage Limit
Joint filers with TI of...	Up to $315,000	$315,000 - $415,000	$415,000 +
Others with TI of...	Up to $157,500	$157,500 - $207,500	$207,500 +

- **At full wage limit, deduction limited to greater of:**
  - **50% of taxpayer's allocable share of W-2 Wages; or**
  - **25% of the taxpayer's allocable share of W-2 Wages plus 2.5% of unadjusted basis of tangible depreciable property**

Section 199A Deduction

- **Example #2: Same as example #1, except Tom reports QBI and taxable income of $450K. Also, the partnership reports W-2 wages of $300K and has no depreciable property**

- **Deduction is equal to the least of (i) 20% of QBI, (ii) 20% of taxable income, or (iii) 50% of allocable share of W-2 wages**
  - **20% of QBI = $90K**
  - **20% of TI = $90K**
  - **Wage Limit = 50% of 50% of $300K = $75K**
  - **Deduction = $75K**

Section 199A Deduction

- For specified service trades or businesses, an additional "applicable percentage" limitation applies to taxpayers with income above the same thresholds as wage limitation
  - Specified service limitation results in complete phase-out of deduction for taxpayers with taxable income in excess of $415,000 / $207,500
  - Specified service trades or businesses include: health, law, accounting, consulting, athletics, various investment or financial services, or any business where the principal asset of the business is the reputation or skill of one or more of its employees or owners

Section 199A Deduction

- Example #3: Same as example #2, except Tom is a partner in a law firm
- Deduction is equal to the least of (i) 20% of applicable percentage of QBI, (ii) 20% of taxable income, or (iii) 50% of applicable percentage of allocable share of W-2 wages
  - 20% of 0% of QBI = $0K
  - 20% of TI = $90K
  - Wage Limit = 50% of 0% of 50% of $300K = $0K
  - Deduction = $0K
- What if QBI and taxable income is $365K?
  - ¯_(ツ)_/¯

Section 199A Deduction

- Issues still to be addressed:
  - What is a trade or business for purposes of Section 199A?
  - What is a specified service trade or business?
  - How is qualified business income calculated for tiered entities?
  - Should the reasonable compensation standard now apply to partnerships?

Section 199A Deduction

- Other issues:
  - Also applies to PTP and REIT dividends
  - Does not reduce employment taxes
  - Does apply for purposes of determining AMT
  - Qualified business losses carry forward for purposes of determining subsequent year's QBI
  - Section 172(d) has been amended to provide that a net operating loss does NOT include the Section 199A deduction
  - Effect on tax distributions
  - Sunsets on December 31, 2025

Section 199A Deduction

- Cooperatives
  - Members receive deduction of 20% of the aggregate amount of "qualified cooperative dividends" received, with the deduction capped at 100% of taxable income less net capital gain
  - Special 20% deduction provided at entity level to agricultural and horticultural cooperatives on gross income in excess of qualified cooperative dividends

Choice of Entity Implications of Tax Act

- In general, Act unlikely to alter pre-Act choice of entity analysis in majority of cases.
  - Rate differential between highest individual and highest corporate rates, especially when taking into account Section 199A deduction, is insufficient to make C corporations a clear winner.
- On the other hand, the Act offers new potential planning opportunities that are dependent upon business entity choice.

Double Taxation – The C Corp Drawback

- "Double Taxation" typically cited as the drawback of a C corporation.
- But whether double taxation is unfavorable is wholly dependent on tax rates.

	C Corporation		Passthrough		
Business Income	$	100.00	$	100.00	Business Income
Federal Corporate Tax Rate		25%		0%	Federal Corporate Tax Rate
Corporate Tax	$	(25.00)	$	-	Corporate Tax
Dividend After Corporate Tax	$	75.00	$	100.00	Passthrough Income
Dividend Tax Rate		25%		50%	Individual Tax Rate
Dividend Tax	$	(18.75)	$	(50.00)	Individual Income Tax
Remaining After Dividend and NIIT	$	56.25	$	50.00	Remaining After Tax
Effective Tax Rate		43.75%		50.00%	Effective Tax Rate

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Historical Tax Rates

- 1969 through 1981
  - Highest marginal rate for individuals = 70%
  - Highest marginal rate for corporations = 46%
  - Effective tax rate on corporate income as high as 83.8% (46% of 100% plus 70% of 54%)
  - Motivation to retain/reinvest income at corporate level if not necessary to distribute
- 1993 through 2017
  - Highest marginal rate for individuals = 35%-39.6%
  - Highest marginal rate for corporations = 35%
  - Rate differential insufficient to motivate accumulation of corporate income
- 2018 through ?
  - Highest marginal rate for individuals = 37%
  - Highest marginal rate for corporations = 21%
  - The motivation has returned

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Motivation to Retain Rather than Distribute Corporate Earnings

	C Corporation - Old Law - Distributes All After-Tax Income	C Corporation - New Law - Distributes 10% ofIncome	Passthrough With No 199A Deduction	Passthrough With Full 199A Deduction	
Business Income	$ 100.00	$ 100.00	$ 100.00	$ 100.00	Business Income
Federal Corporate Tax Rate	35%	21%	0%	0%	Not Applicable
State Corporate Tax Rate	5%	5%	0%	0%	Not Applicable
Corporate Tax	$ (40.00)	$ 26.00	$ 100.00	$ 100.00	Passthrough Income
Dividend After Corporate Tax	$ 60.00	$ 10.00	$ -	$ (20.00)	Less 20% 199A Deduction
Dividend Tax Rate	20%	20%	$ 100.00	$ 80.00	Ordinary Income
NIIT Tax Rate	3.8%	3.8%	37%	37%	Federal Individual Tax Rate
State Individual Tax Rate	5%	5%	5%	5%	State Individual Tax Rate
Dividend Tax and NIIT	$ (17.28)	$ (2.88)	$ (42.00)	$ (33.60)	Income Tax
Remaining After Dividend and NIIT	$ 42.72	$ 71.12	$ 58.00	$ 66.40	Remaining After Income Tax
Effective Tax Rate	57.28%	28.88%	42.00%	33.60%	Effective Tax Rate

Potential Planning Opportunities

- **Senior generation owners of existing businesses operated as C corporations**
  - **Reinvest**
    - **Avoids the second layer of tax during the owner's lifetime.**
    - **Value appreciation as a result of reinvestment escapes income tax at owner's death because of step up in basis.**
  - **Fixed Income Investments**
    - **Make fixed income investments in corporation rather than individually.**
    - **Low to no appreciation taxed if later distributed**
    - **Low corporate rates during life of investment**
    - **Possibility of escaping all tax if corporation liquidated after death because of step up in basis**
  - **Sale of Short-term Capital Gain or Collectibles**
    - **Contribute STCG assets that will be sold or collectibles to corporation pre-sale**

Accumulated Earnings Tax

- IRS's principal weapon against corporate retention of earnings.
- Historical significance when rate differential was greater.
- Has been dormant/irrelevant for decades.
- Reinvigorated by rate changes in Act.
- Purpose is to minimize revenue losses caused by nondistribution of earnings by corporations attempting to shield their shareholders from the individual income tax.
- Penalty tax—not self-assessed; only arises on audit.
- Horrible result if it is sustained.

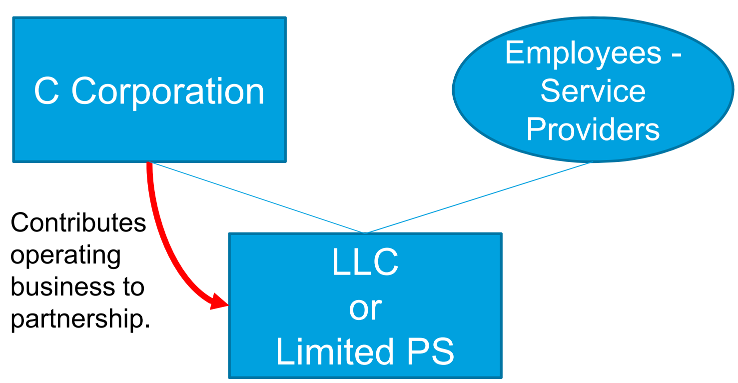
Accumulated Earnings Tax

- Applies to a corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . , by permitting earnings and profits to accumulate instead of being divided or distributed."
- Accumulating earnings beyond the reasonable needs of the business is determinative of tax avoidance purpose, unless corporation proves otherwise by a preponderance of the evidence.
- Being "a mere holding or investment company" is prima facie evidence of tax avoidance purpose.

Accumulated Earnings Tax

- **Key Takeaways on AET**:
  - **Unlikely to apply in operating company context.**
  - **IRS has had limited success in asserting the AET.**
  - **It does, however, prevent taxpayers from simply parking investment assets to which they don't need access in a newly formed C corporation, enjoying the low corporate rates, and holding the corporate stock until death to benefit from the step up in basis.**

Passthrough Planning Opportunities



Passthrough Planning Opportunities

- Possible Advantages of Structure
  - For Profit Corporations
    - Potential to convert compensation into income subject to 199A deduction.
  - Tax-Exempt Organizations
    - 21% excise tax on compensation in excess of $1 million.
    - Structure may allow similar avoidance.

New York CLE Code

Section 162(m)

- Section 162(m) and its associated regulations govern the deductibility of compensation paid to specific executive officers ("covered employees") of a publicly traded company.
- In general, Section 162(m) disallowed a publicly held company's deductions for compensation in excess of $1,000,000 paid to a "**covered employee**" unless the compensation met the requirements for an exception for "**performance-based" compensation**".
- The TCJA made significant changes to the rules pertaining to the limit on deductions for compensation in excess of $1,000,000 paid to covered employees.

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Section 162(m)

- **TCJA expands definition of "publicly held corporation"**
- Effective for taxable years beginning on or after January 1, 2018, the TCJA expands the definition to include any corporation which is:
  - An issuer of securities required to be registered under section 12 of the SEA (not limited to equity securities); or
  - Required to file reports under section 15(d) of the SEA (new rule now includes issuers that file registration statements for debt or equity securities, even if the securities are not listed on an exchange).

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Section 162(m)

- **TCJA expands definition of "covered employee"**
- The TCJA revises the definition of covered employee to more closely track the definition in current SEC disclosure rules, and expands the definition as follows:
  - **The principal executive officer (PEO) and the principal financial officer (PFO) of the corporation at any time during the tax year,**
  - **Next three highest-paid named executive officers other than the PEO or PFO.**
  - **Evergreen covered employee status.** If an individual was a covered employee of a corporation for a tax year beginning after December 31, 2017, the individual will remain a covered employee for all tax years in which the individual receives compensation from the corporation. This includes:
    - **NEOs transitioning to non-NEO positions in the corporation are affected.**
    - **Nonqualified deferred compensation payments following severance from employment or retirement are impacted.**

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Section 162(m)

- **TCJA eliminates exception for performance-based compensation**.
- **Transition relief**. A performance-based compensation will not be subject to the deduction limit ("grandfathered"), provided that:
  - Remuneration provided pursuant to a written binding contract in effect on November 2, 2017;
  - The written binding contract is not modified in any material respect on or after such date, or renewed on or after such date; and
  - The amounts payable are not subject to discretion. It is unclear whether the use of negative discretion would cause the plan to lose grandfathered status. (*See* Conference Committee report (H. Rept. 115-466)*; example does not define what constitutes "discretion."*)
  - <u>Note</u>. This transition relief is not codified and may be found in the TCJA. (*See* Sec. 13601 of the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97.

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Section 83(i)

- **Deferral opportunity**. Under Section 83(i), a "**qualified employee**" may elect to defer the income attributable to shares under a stock option or restricted stock unit (RSU) received in connection with the performance of services for up to five years if the corporation's stock is from an "**eligible corporation**."
- **Available to private corporations only**. A corporation is an "eligible corporation" with respect to a calendar year if no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year.

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Section 83(i)

- **Not available to certain executives and owners**.
  - All current and former CEOs, CFOs excluded
  - Four highest compensated officers in any tax year excluded (ten year look back)
  - Current and former 1% owners also excluded (ten year look back)
- **80% participation requirement**. The corporation must have a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States are granted stock options or RSUs with the same rights and privileges to receive qualified stock.
- Private corporations with broad-based compensatory stock option or RSU programs may wish to evaluate.

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Section 4960

- **TCJA adds new Section 4960 excise tax applicable to tax-exempt entities**
  - Tax exempt organizations are required to pay an excise tax on the following compensation paid to "covered employees":
    - "excess remuneration" - compensation exceeding $1 million for a given tax year (modeled after Section 162(m); and
    - "excess parachute payments" contingent upon separation from service (modeled after Section 280G).
  - The tax on compensation over $1 million and the tax on excess parachute payments operate independently.
  - This tax is 21 percent of the amount exceeding $1 million (21 percent is the corporate tax rate under the new law).

Section 4960

- **"Covered employees"**
  - Any current or former employee among the five highest-paid employees for a taxable year, as well as any employee who was a covered employee in a prior year.
- **Exempt remuneration.** Excise tax does not apply to payments made to licensed medical professionals (physicians, nurses and veterinarians), to the extent compensation payments relate directly to performance of medical services
- No grandfathering of pre-existing compensation arrangements

What's NOT in TCJA?

- **Section 409B**. Provision would have taxed non-qualified deferred compensation at vesting (original Ways and Means Committee bill and Senate Finance Committee proposal)
- **Limitation on catch-up contributions**. Would have disallowed catch-up contributions for employees who receive wages of $500,000 (original Senate Finance Committee proposal).

Objectives of the International Tax Changes

- **Encourage U.S. Companies to Repatriate Cash to U.S.**
- **Make America More Competitive**
- **Reduce the Tax Incentives for U.S. Companies to Engage in Inversions**

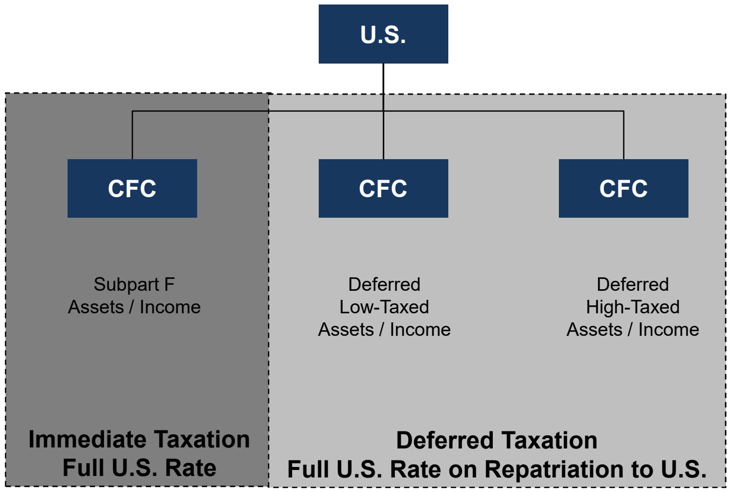
New Approach to International Tax Planning

- U.S. federal corporate income tax rates are now lower than federal corporate tax rates in many developed nations
- Many foreign corporations with U.S. subsidiaries have structured their cross-border arrangements to maximize deductions in their U.S. subsidiaries and thereby reduce the amount of taxable income subject to U.S. tax
- Now that the situation has flipped, cross-border structures need to be reviewed and in many cases restructured
- Review transfer pricing arrangements
- Don't forget state, local and provincial taxes
- Should new ventures be formed in a foreign country or the U.S.?
  - Answer is now more difficult

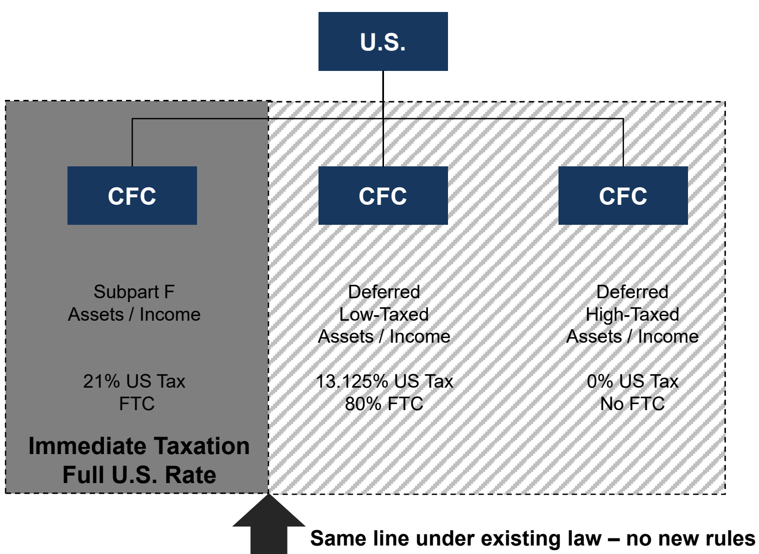
One-Time Tax on Accumulated Offshore Earnings

- U.S. based multinational corporations hold an estimated U.S. $2-3 trillion in earnings accumulated in foreign subsidiaries
  - Under prior law, foreign earnings repatriated to the U.S. parent were subject to a 35% U.S. income tax less any applicable foreign tax credit
- A 15.5% tax is imposed on pre-2018 earnings to the extent of foreign cash and liquid assets
- Balance of pre-2018 earnings is taxed at 8%
- Tax may be paid over 8 years without interest
- Pre-2018 earnings may be repatriated without additional U.S. tax
  - Dividend withholding taxes assessed by foreign countries may apply
- Foreign tax credits are partially available

Prior U.S. International Tax System



New U.S. Territorial System



Subpart F Income

- Certain Income of Controlled Foreign Corporations (“CFC”)
  - Dividends, Interest, Passive Rents, Passive Royalties, etc.
  - Business income that has no economic connection to the CFC’s country of incorporation
- Continued immediate inclusion in U.S. Parent’s taxable income
- Foreign tax credit available

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Global Intangible Low-Taxed Income (“GILTI”)

- Imposes a minimum tax on 10% U.S. shareholders of CFCs to the extent the CFCs have GILTI
- Computation of GILTI is complex
  - In general terms, GILTI is all the CFC’s income excluding U.S. business income, Subpart F income, dividends and certain other specified income
  - GILTI is reduced by a deemed 10% return on the aggregate tax basis in tangible depreciable property
- U.S. corporate 10% shareholders only include 50% of the foregoing amount in GILTI, resulting in an effective tax rate of 10.5%
- 80% of foreign tax credits are available to 10% corporate shareholders
- After applying the 80% foreign tax credits, GILTI of CFCs which pay foreign tax of at least 13.125% will not be subject to additional U.S. tax

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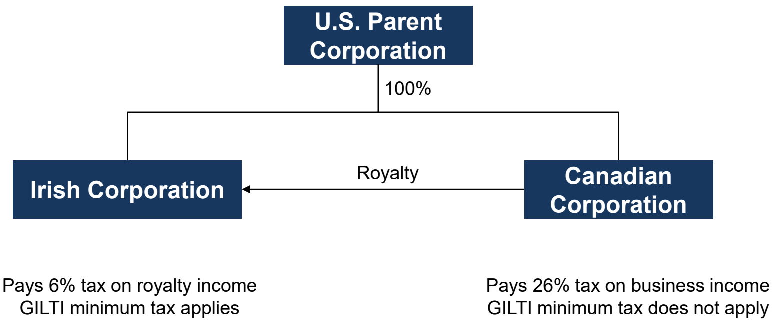
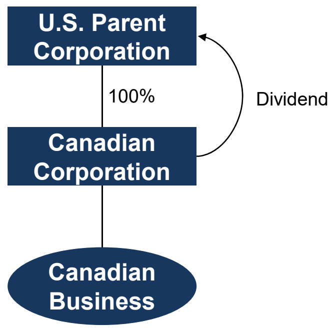
GILTI Example



Foreign Source Dividends Received Deduction "Participation Exemption"

- **Allows a U.S. corporation to deduct the foreign-source portion of a dividend received from a specified 10% owned foreign corporation held by a U.S. corporation**
- **"Specified 10% owned foreign corporation" means any foreign corporation with respect to which any U.S. corporation owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation**
- **Dividends from "passive foreign investment companies" are ineligible**
- **One year holding period**
- **No foreign tax credit, including withholding taxes**

Foreign Source Dividends Received Deduction



- U.S. Parent receives a deduction equal to the amount of the dividend and effectively pays no U.S. tax on such dividend
- U.S. Parent does not receive a foreign tax credit for the Canadian dividend withholding tax of 5%

Foreign Derived Intangible Income "FDII"

- FDII allows a deduction for eligible C corporations that reduces the effective U.S. tax rate on foreign-derived income treated as attributable to intellectual property and other intangibles
- Computation is complex – conceptually similar to GILTI but applies to foreign source "intangible" income earned by U.S. corporations
- The FDII brings the effective tax rate down from 21% to 13.125% on foreign source "intangible" income
- Effective rate increases to 16.406% after 2025
- Objectives are to encourage American exports and, together with GILTI, attempts to make taxes a neutral factor in determining whether to own intellectual property in a U.S. entity or low-tax foreign entity

Base Erosion and Anti-Abuse Tax "BEAT"

- Designed to limit the use of U.S. tax base-stripping payments by U.S. corporations
- Acts as a corporate alternative minimum tax
- Applies to corporate groups with average annual gross receipts of $500 million for the preceding 3 years and a base erosion percentage of 3% or more
  - Only gross receipts effectively connected with a U.S. business are taken into account
- BEAT = (10% of modified taxable income) minus regular tax liability
- Modified taxable income is generally the U.S. corporation's regular taxable income plus certain base erosion payments
  - Base erosion payments are generally deductible payments paid or accrued to 25% related foreign persons.
- Rate is 5% in 2018
- Rate increases from 10% in 2019 to 12.5% in 2026

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BEAT Erosion Payments

- Included:
  - Interest
  - Payments for acquisition of property that gives rise to a depreciation or amortization deduction
  - Payments for services
  - Premiums or other consideration for reinsurance
  - Royalties
- Excluded:
  - Costs of goods sold unless paid to 60% inverted group members
  - Payments to the extent subject to U.S. withholding tax
  - Payments for intercompany services that qualify to be charged at cost
  - Qualified derivatives payments

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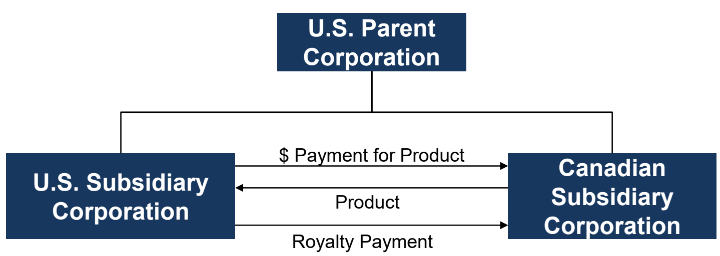
BEAT Considerations

- As a minimum tax, may be manageable for some companies
- Manufacturers are advantaged in comparison to service providers and financial institutions, due to cost of goods sold exclusion
- Services companies should consider restructuring global service contracts so that foreign affiliates earn fees directly

BEAT Example



- U.S. Subsidiary purchases product and makes royalty payments to Canadian Subsidiary
- Royalty payment is a base erosion payment
- Payment for product (cost of goods sold) is <u>not</u> a base erosion payment

Credit Agreements – Section 956

- Retention of Section 956 creates trap for the unwary
- Section 956 deems CFCs to pay dividends to their U.S. shareholder if the CFC provides direct or indirect credit support for U.S. shareholder's debt
- Under new dividend exemption system, an actual dividend from the CFC would be tax exempt
- However, Section 956 deemed dividends subject to 21% tax
- Credit Agreements often exclude to avoid Section 956 income inclusions:
  - Guarantee or pledge by any CFC
  - Pledges of more than 66-2/3% of voting stock of CFCs or U.S. holding companies that hold CFC stock and have no other material assets or operations

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Credit Agreements – Section 956 (cont.)

- Before agreeing to these types of exclusions, lenders should evaluate whether Section 956 inclusions will have a material adverse impact on the borrower
  - With the reduction of the corporate tax rate to 21%, foreign tax credits may be available to offset the tax otherwise due
  - With the new participation exemption CFCs can pay dividends to their U.S. parent without triggering additional U.S. tax and thereby reduce potential inclusion under Section 956

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Hybrid Deductions Denied

- Targets double-dip structures
- No deduction for related-party interest and royalty payments if there is no inclusion in income (or if there is a deduction) on the recipient side
- Applies to hybrid payments and payments to hybrid entities
- Regulatory authority to address other transactions

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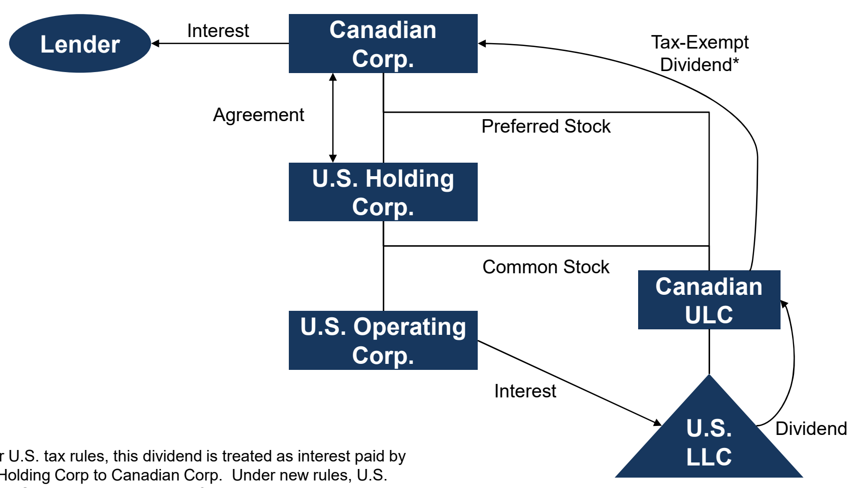
Double-Dip Interest Deduction Denied



* Under U.S. tax rules, this dividend is treated as interest paid by U.S. Holding Corp to Canadian Corp. Under new rules, U.S. Holding Corp is no longer eligible for this interest deduction.

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Hybrid Mismatch: Issues

- IRS has authority to issue regulations covering:
  - Conduit arrangements
  - Foreign branches
  - Structured transactions
  - Preferential regimes
  - Participation exemption and similar systems
  - Tax residence of dual-resident or nowhere entities
  - Exceptions
  - Recordkeeping and information reporting requirements

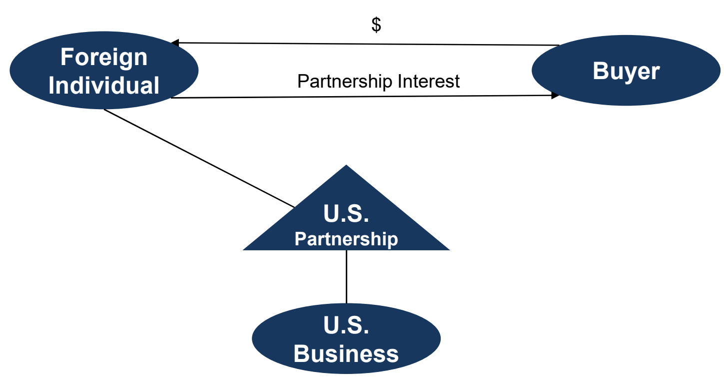
Disposition of Interests in Partnership Engaged in a U.S. Trade or Business, General Provisions

- U.S. tax applies to the disposition, by a nonresident alien individual or foreign corporation, of an interest in a partnership that is engaged in a U.S. trade or business
  - Gain or loss on the sale or exchange of the interest is treated as effectively connected income ("ECI") to the extent of the selling partner's distributive share of gain or loss that would be treated as ECI if the partnership sold all of its assets at FMV immediately before the sale or exchange of the partnership interest
  - The rule is coordinated with the FIRPTA rules so that gain from the sale of FIRPTA assets is not double counted
  - In the case of a partner entitled to the benefits of a U.S. tax treaty, would IRS and Treasury view the treaty as limiting the reach of this new rule similar to the way in which Rev. Rul. 91-32 applied in the treaty context?

Disposition of Interests in Partnerships Engaged in a U.S. Trade or Business, Withholding

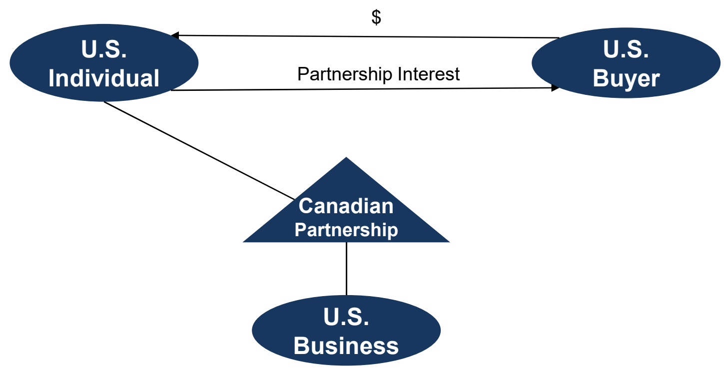
- This provision imposes a withholding obligation related to a sale or exchange of a partnership interest that is subject to the ECI rules
- If any portion of the gain on the sale or exchange of the partnership interest is treated as ECI, the transferee is required to withhold 10% of the amount realized
  - The entire amount realized on the disposition of the partnership interest is subject to withholding. It does not appear to be limited to only the amount that is treated as ECI
  - Regulatory authority is granted to provide for reduced withholding
  - An exemption from withholding is provided if the transferor signs an affidavit, under penalties of perjury, that states that the transferor is not a foreign person and includes the transferor's taxpayer identification number
- If a transferee fails to withhold under the general rule, the partnership is required to withhold on distributions to the transferee partner in an amount equal to the amount the transferee failed to withhold (plus interest)
- The general rule is effective November 27, 2017 but the withholding tax provision becomes effective for transfers after December 31, 2017

Disposition of Partnership Interest Example



- Foreign individual is subject to U.S. tax on the sale of its partnership interest
- Buyer must withhold 10% of gross sale price and deposit such amount with the IRS
- If Buyer does not withhold, Partnership must withhold from future distributions to Buyer

Disposition of Partnership Interest Example



- **To avoid withholding, Buyer must obtain non-foreign status certificate from U.S. seller**

Inversions Less Attractive

- **Several inverted companies, including Eaton, Johnson Controls and Valeant Pharmaceuticals, announced that the new tax law will increase their effective tax rates**
  - **Limits on Interest deductions (estimated to raise $253 Billion)**
  - **BEAT (estimated to raise $150 Billion)**
- **Individual shareholders who receive a dividend from a corporation which becomes an “inverted” foreign corporation after November 9, 2017 is not entitled to the lower rates on qualified dividends**