Four big questions on US tax reforms.

Assessing the implications of the Tax Cuts and Jobs Act
In December 2017 the US unveiled plans for the biggest shake-up of its tax system in 30 years. Global businesses have now had time to digest what the reforms mean for them and to think about how they should respond.

Many of the new measures are benefiting US-headquartered companies, not least the cut in the corporate tax rate from 35 to 21 per cent. But changes to the treatment of non-US income and a revised anti-abuse regime have made decisions about where to invest – and how to structure cross-border operations – particularly complex thanks to the way the international tax aspects of the reforms operate together.

In order to assess the impact of the US reforms on global businesses we have conducted a series of in-depth interviews with multinationals, academics, tax advisory bodies and international member organisations across Europe, North America and Asia. Combining their insights with those of our tax partners across the world we have addressed four big questions that flow from the introduction of the Tax Cuts and Jobs Act.

- How will the changes affect inbound investment?
- What impact will they have on corporate structuring?
- What do the new rules mean for international tax co-operation?
- What issues remain unresolved?

We are advising our clients – both within and outside the US – on how best to respond to the changes, particularly in relation to M&A, and have a detailed understanding of the challenges and opportunities they face.

If you would like to discuss how the US reforms – or any other international tax issue – could affect your business, we would be delighted to hear from you.

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Capital gains?

What the US tax reforms mean for inbound investment
If President Trump was looking for early approval of his sweeping changes to the US tax system, some of the country’s biggest companies were happy to oblige.

Just a month after the president signed the Tax Cuts and Jobs Act on 22 December 2017, JPMorgan Chase unveiled details of a $20bn, five-year plan to grow its US business. ‘This long-term investment… is made possible by the firm’s strong and sustained business performance, recent changes to the US corporate tax system and a more constructive regulatory and business environment,’ it said in a statement.¹

On the same day The Walt Disney Company announced one-off bonuses for more than 125,000 employees and a $50m payment towards tuition costs for staff on hourly wages.² Bank of America, Walmart and AT&T joined the bonus bonanza.

Two headline-grabbing features of the overhaul were welcomed by business. One was the decision to slash the corporate tax rate from 35 to 21 per cent. The other was the introduction of immediate expensing, a temporary mechanism that enables companies to invest in certain plant and equipment in the US – or to buy other companies – and deduct all of the cost from their taxable income. The deduction, which does not apply to investments in goodwill and other intangible assets, will be gradually reduced between 2022 and 2027.

It seemed clear at the start of 2018 that the US tax system had been recast to create an incentive for multinationals to generate a bigger slice of their revenue within the US.

Nine months on, that narrative has begun to unravel. US companies announced plans for nearly $437bn in share buybacks during the second quarter of 2018,³ fuelling arguments that executives are using the windfall to boost share prices rather than to fund real growth initiatives.

Further, while the US tax rate has come down, the reforms in their entirety have a more complex effect on business. Companies are finding that the decision on whether to invest more in the US is not as clear-cut as it first appeared, thanks to the way the international tax aspects of the reform – the base erosion and anti-abuse tax (BEAT) provision, and the foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) regimes – operate together.

Adding to the uncertainty is the fact that the US Treasury is still working on the guidance that will show how the reforms will be interpreted.

2. 125,000 Disney Employees to Receive $1,000 Cash Bonus and Company Launches New $50 Million Higher Education Program, The Walt Disney Company, January 2018.
For Meera Patel, Tax Director of the German multinational chemicals company BASF, the 14-point cut in the corporate tax rate had obvious appeal. ‘When we make investment decisions we always do an after-tax view,’ she says. ‘We look at the discounted cash flows and assess the net present value benefit of an investment when comparing different targets or different locations for plants. Obviously, when you input the new US tax rate into that, US investments become much more attractive.’

But businesses are not assuming that the corporate tax rate will remain this low for the long term. Firstly because control of Congress is up for grabs in November’s midterm elections. And also because it remains unclear whether President Trump will run for a second term in 2020.

If we invest today, we might only realise the profits after five, six, or seven years. By then the rates may have gone up again,’ says Christian Dorenkamp, Global Head of Tax at Deutsche Telekom. ‘I’m not sure we’re going to be at 21 per cent in five years’ time, but I also don’t believe we’ll make it back up to 35 per cent. I think it’s more likely to be somewhere nearer 25 per cent.’

Then there’s the immediate expensing rule, which is designed to create an incentive for certain types of investment but is only temporary (see page 7). While it applies, capital expenditure and M&A deals that can be structured as asset purchases are more attractive than before, although the potential inflationary impact of immediate expensing and a much-lower tax rate on asset prices needs to be taken into account.

Dealing with new taxes

While one of the principal goals of the tax reforms has been to encourage multinationals to expand in the US, the Trump administration is also keen to ensure the proceeds of that expansion remain on US soil. One way is via the BEAT provision, which is a 10 per cent minimum levy on payments such as interest and royalties made by US corporations to group companies outside the US.

If the Democrats got into power and immediately backtracked by putting in an aggressively higher rate, a lot of people would say that would not be smart politically. They may try to do something more balanced, with a moderate rate increase, just to manage the long-term US budgetary outlook. This is just a guess, but they might opt for somewhere around 25%.

Kari Pahlman, Vice President of Global Tax, Techtronic

A waiting game

The US tax authorities are yet to publish much of the guidance required by inbound investors to fully interpret the reforms, and as a result many are putting decisions on hold until they have greater clarity. Some companies have had difficulties modelling the impact of the reforms because of the sheer complexity of the way the different measures work together, the speed with which the reforms were enacted and the consequent doubts about how long-lasting some aspects of them will be.

Companies are expecting a flood of guidance from the Treasury Department soon. Only then will they be able to plot a course with confidence.
## Potential impact of US tax reform on inbound investors

<table>
<thead>
<tr>
<th>What it is</th>
<th>How does it affect inbound investors?</th>
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<tbody>
<tr>
<td><strong>Base erosion and anti-abuse tax (BEAT)</strong></td>
<td>A minimum tax on payments by US corporations to related non-US corporations. Payments include interest, royalties, and certain management services fees and depreciation expenses, though not cost of goods sold. The US corporation has to be part of a group of a certain size, i.e., an average of $500m in US income over a three-year period, and payments have to be a certain percentage of its total tax deductions for the year.</td>
</tr>
<tr>
<td><strong>Interest limitation</strong></td>
<td>Interest deductions will be limited to total interest income plus 30 per cent of EBITDA (earnings before interest, taxes, depreciation and amortisation) (EBIT for periods on or after 1 January 2022).</td>
</tr>
<tr>
<td><strong>Immediate expensing</strong></td>
<td>Immediate and full expensing for certain property acquired and used after 27 September 2017 and before 2023. This provision is reduced by 20 per cent each year from 2023 to 2026.</td>
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<tr>
<td><strong>Hybrid payments</strong></td>
<td>Limits the deductibility of payments on hybrid instruments (treated as deductible in the US and exempt in the jurisdiction where the foreign business is tax resident) or by hybrid entities (treated as corporations in the US and transparent in the residence jurisdiction, or the reverse).</td>
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Four big questions on US tax reforms

The Tax Cuts and Jobs Act replaces a fiscal regime that had little support in US boardrooms.

Under the previous framework, some companies faced an overall rate of 40 per cent once state and local charges were taken into account, one of the highest tax burdens in the West. The old rules also had global application, with the goal of ensuring US-headquartered multinationals paid no less than 35 per cent on any repatriated profits. It was this that led many companies to hold their cash overseas, and some to ‘invert’ their headquarters to a more favourable jurisdiction.

President Trump’s reforms have instituted a hybrid system that exempts some earnings through foreign subsidiaries from tax and imposes immediate taxation at a reduced rate on the remainder. In addition, the reforms imposed a one-off levy to encourage global companies to bring their offshore cash home. These measures combine to eliminate an incentive to defer repatriation of offshore earnings.

Also included in the reforms is a mechanism allowing immediate expensing of capex investment (enabling businesses to deduct from their taxable income anything they spend in the US on certain plant, equipment and other tangible assets), and a more favourable treatment for intellectual property (IP).

Put together, the changes are designed to encourage multinational groups to restructure their operations so that more of their economic activity takes place on US soil. So are they working?

Stick or twist?
What the US tax reforms mean for corporate structuring

The tax reforms are designed to make the US a more attractive place to invest and locate commercial activity.

Lower corporate tax rate and more favourable treatment for IP and non-US revenue may influence group structuring decisions.

But some multinationals would have more to gain than others from restructuring and adapting transfer pricing.

Which businesses would benefit most? And what is influencing their decisions?
Corporate tax rates in the OECD

Transfer pricing impact

Multinationals’ transfer pricing policies typically consider the company’s global footprint and book costs and profits in high- and low-tax jurisdictions, respectively.

The GOP tax bill has changed where the US comes out in this calculation; prior to the reforms it had the highest corporate rate and the highest overall tax burden in the Organisation for Economic Co-operation and Development (OECD). Now it sits 15th on the list of headline rates and 22nd when state and local taxes are taken into account. Its total tax burden is now lower than in Canada, Mexico, France and Germany, but still higher than countries including Ireland and Hungary.

To understand the implications for group structuring and transfer pricing, multinationals have to consider the impact of other measures in the reforms too, which affect companies in different ways depending on how they are organised.

The new FDII regime, for example, is a major positive for some groups that already hold IP in the US, and those that do not are now assessing whether it makes sense for them to change their plans. FDII, which applies for the tax years beginning after 31 December 2017 and before 31 December 2025, taxes the income US corporates earn from foreign licensing and from exporting goods and services, to the extent that income exceeds a routine (10 per cent) return on tangible business assets, at 13.125 per cent rather than 21 per cent. This income would include, but not be limited to, income attributable to IP used outside the US. Importantly, it is open to US subsidiaries of foreign multinationals, giving global groups
Four big questions on US tax reforms

an incentive to shift both their IP used outside the US and their manufacturing for export to the US.

Then there is the GILTI provision, which again applies to US subsidiaries of foreign multinationals. This anti-avoidance measure (which, despite its name also covers tangible assets) imposes a nominal 10.5 per cent rate – the US corporate rate of 21 per cent less a generally available 50 per cent deduction – on a US shareholder’s income from a controlled foreign corporation (CFC) to the extent this exceeds a routine return on tangible business assets. After taking into account the GILTI provision, the new US system is not a true territorial system, since non-US earnings, even from foreign subsidiaries, are subject to some tax.

Kari Pahlman, Vice President of Global Tax for Techtronic, a Hong Kong-based tech company with substantial operations in Asia, Europe and the US, explains that FDII is causing his company to reconsider a previous plan to shift IP out of the US, but that overall the provision is more beneficial for US businesses. ‘If you are a non-US, inbound company, you would be looking to structure your operations around BEAT [a new tax on payments by US corporations to foreign affiliates] rather than FDII. That really is the inbound issue,’ he says.

There are clearer benefits under the FDII regime for US companies that have taken advantage of lower tax rates on offer in Europe – for example in Ireland or the Netherlands – without putting substantial investment or people there. Under the new rules they may see advantages in de-risking their operations and reorienting their activities back towards the US.
Reacting to BEAT

While mechanisms like FDII lower the tax burden for many, there are other aspects of the reforms that work in the opposite direction. BEAT, for example, is designed to prevent multinational groups with equity capital and intangible assets used in the US from holding those assets in low-tax jurisdictions and then using payments of loan interest, IP royalties and certain management service fees to strip earnings from the US tax base.

As one interviewee noted, the complexity of income flow within multinational groups will mean that most are likely to prefer tax planning, rather than wholesale restructuring, to reduce their liabilities under BEAT. Others echoed this view, pointing out that tax is a consideration when developing corporate strategy, rather than a driver of it.

Investment pressure

It is also worth noting that any change that reduces the tax a business pays in a particular country could provoke a reaction – especially if it involves shifting capital investment or jobs.
Tax is a consideration when developing corporate strategy, rather than a driver of it.

Those repercussions might come in the form of incentives designed to force a rethink. But they could just as likely involve penalties; the EU’s Anti-tax Avoidance Directive, for example, sets out rules for exit taxes, anti-abuse measures and the treatment of CFCs, to discourage companies from taking advantage of more favourable regimes elsewhere.

Our interviewees felt Asian governments’ heavy reliance on foreign investment for economic growth made them less likely to take action against companies responding to the US reforms with such restructuring. But even here there are limits. ‘I think Asian countries would take the view that if a multinational is shifting its investment strategy towards the US, they would engage in tax incentive competition to encourage MNEs [multinational enterprises] to consider, or keep, investing in their country,’ says Kari Pahlman. ‘It also remains to be seen how widespread any shift in investment flows to the US will be as a result of these reforms. If they become material then action may follow, but at the moment I don’t think we’re seeing that.’

On the surface, the US tax reforms introduce a number of measures that are being discussed as companies think about where to channel investment and how to structure their operations. But the lack of guidance from the Treasury Department about how it intends to interpret the new law means that hard decisions are being put on hold for now.

Guidance on the return of US companies’ overseas revenue has now been published along with some initial proposed regulations on GILTI. Guidance on the interpretation of BEAT and other international provisions is set to follow by the end of the year, with all other regulations to come before June 2019.

Tax executives will welcome the clarity that these guidelines will bring, but with the various measures in the new tax law interacting with one another in complex ways, it may be some time before major decisions can be taken with confidence. Moreover, the prospect of a change in the control of the US Congress in the November elections, and of the White House two years later, raises the possibility of some modifications to the new tax law, including a possible increase in the US corporate tax rate.

Unintended consequences: Will reputation and bonuses also influence restructuring decisions?

Tax has become inexorably linked to corporate reputation, particularly in Europe. Citizens have made it clear that they want businesses to pay tax where income is earned, rather than relying on complex structures to channel it to the jurisdictions with the lowest rates. Restructuring decisions – particularly for consumer-facing companies – need to be taken with this dynamic in mind.

There are other, less obvious, consequences of changing the way money flows between group companies. If a division stands to lose revenue because of a shift in transfer pricing policy, it can have a material impact on staff whose remuneration is pegged to financial performance. Businesses may therefore need to consider amending their employment contracts at the same time as their corporate structures if they are to retain top talent.
America first?

What the US reforms mean for international tax co-operation

After two years of sometimes painful negotiations, the OECD unveiled its BEPS Action Plan in October 2015.

Designed to smooth the cross-border inconsistencies used by corporations to cut their tax bills, the plan stressed that multilateral action was vital to avoid “the emergence of competing sets of international standards... that could lead to global tax chaos”.5

With this in mind, there was widespread concern two years later as Congress edged towards a vote on transforming the US tax system. Donald Trump had been elected on an ‘America First’ agenda that had already seen him withdraw from several international agreements. Some OECD members now feared the world’s biggest economy would abandon the principles agreed in the base erosion and profit shifting (BEPS) talks, and in doing so usher in a new era of global tax competition.

While the US had been engaged in the BEPS project from the outset, the relationship had never been smooth. During the Action Plan talks there were rumours Washington saw the initiative as an attack on the international strategies of US multinationals.6 However, the US was also keen to downplay any dissatisfaction it may have felt, with Robert Stack, its then-lead delegate to the OECD’s Committee on Fiscal Affairs – which signs off on the organisation’s tax programme – telling Tax Analysts’ magazine in December 2014 that “it wouldn’t be entirely fair to paint the BEPS initiative as “the US against the world””.7

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US tax reforms vs BEPS: three key areas of alignment

The reform enacts a large part of the Action 2 recommendation against avoidance by hybrids.

**US tax reform:** Deductions denied for any amount paid by a related party where the amount is not taxable, or a deduction is available, in the jurisdiction where the related party is resident.

**BEPS Action Plan:** Action 2 – recommends denying dividend exemptions for deductible payments under financial instruments; preventing hybrid transfers being used to take the form of credits for taxes withheld at source; and ensuring CFC and other offshore investment regimes allow for the taxation of hybrid entities in the investor jurisdiction.

*Hybrids are typically set up to gain a tax advantage where there are differences in the tax treatment of the same instrument or entity between jurisdictions.*

The reform is similar to the BEPS Action Plan, bringing treatment of debt and equity more in line in a bid to reduce excess borrowing by US affiliates of multinational corporations.

**US tax reform:** Interest deductions will be limited to total interest income plus 30 per cent of EBITDA (earnings before interest, taxes, depreciation and amortisation) (EBIT for periods on or after 1 January 2022).

**BEPS Action Plan:** Action 4 – recommends a fixed ratio rule that limits an entity’s net deductions to a percentage of its EBITDA.

GILTI, though it is charged on an aggregate basis, is similar to CFC rules in other countries, which are often triggered by minimum effective tax rates. That is, if a CFC is based in a jurisdiction whose headline tax rate is below a certain fixed number, or is lower than that in the home country of the group’s parent by a certain percentage, then the CFC rules apply.

**US tax reform:** GILTI – a minimum tax that applies to any US individual or corporate taxpayer with a stake of at least 10 per cent in a CFC. The rate is 10.5 per cent for taxable years beginning after 31 December 2017 and before 1 January 2026 and 13.125 per cent for taxable years from 1 January 2026 on any income that represents a return of 10 per cent or more from certain tangible assets of the CFC.

**BEPS Action Plan:** Action 3 – six ‘building blocks’ for the design of effective CFC rules: definition of a CFC; exemptions and threshold requirements; definition of income; computation of income; attribution of income; prevention and elimination of double taxation.
The US has now implemented many of the BEPS measures. They’ve done more than the minimum standards.

Achim Pross, Head of International Co-operation and Tax Administration Division, OECD

Reason to be positive

So were the worries of autumn/winter 2017 justified? Nine months on from the introduction of the Tax Cuts and Jobs Act, the elements that deal with international taxation appear to have kept far closer to the BEPS Action Plan than many had predicted. A number of the issues tackled by the OECD project are prominent in the US reforms (see page 15), and US Treasury officials such as Chip Harter, Deputy Assistant Secretary (International Tax Affairs), are on the record saying the US has no intention of backing away from international tax co-operation.

As well as the reforms outlined above, Achim Pross, Head of the International Tax Co-operation and Administration Division at the OECD, says there are other areas where the new US rules are closely matched with BEPS — and where the US continues to work closely with the international community.

‘Actions 8–10 [which deal with transfer pricing] are largely consistent with the US rules, and work is ongoing,’ he says. ‘On Action 14, which covers dispute resolution, the US is religiously doing the work because it has always been keen to develop effective dispute resolution mechanisms. There is no indication from anywhere that the US is not fully engaged in the OECD’s work.’

Beware divergence

Others are less convinced. The finance ministers of Germany, France, Italy, Spain and the UK wrote to US Treasury Secretary Steven Mnuchin to voice their concerns about the US reforms’ BEAT and FDII provisions. They argue that the FDII regime goes further than similar arrangements in other countries in relation to the way IP is created and used. In doing so, it creates an incentive to transfer IP to the US that could erode their own tax bases.

‘The design of the regime is notably different from accepted IP regimes by providing a deduction for income derived from intangible assets other than patents and copyright software, such as branding, market power and market-related intangibles,’ they wrote. ‘[As a result] it would not be compatible with the BEPS consensus that has been approved by more than 100 states and jurisdictions worldwide.’

The mismatch they refer to is with BEPS Action 5, which explicitly excludes ‘marketing-related IP assets such as trademarks’ from favourable tax treatment under IP regimes. Action 5 says that only patents and their functional equivalents – which need to be approved and registered – should qualify.

One tax director we interviewed was hawkish on whether the US reforms bring Washington closer to the international community. Despite acknowledging that elements like the interest limitation provisions mirror structures found elsewhere, he believes that on balance the US reforms represent a divergence from BEPS. ‘It’s interesting that BEAT is not a transfer pricing provision,’ he says. ‘Irrespective of the pricing, a deduction is categorically denied. BEPS is fundamentally about transfer pricing, and while the US reforms create a similar outcome, they do it in a different way. To me, they introduce concepts that BEPS was trying to abolish, and in doing so represent a step away from the international system.’

Another tax director we spoke with said that while the German government is considering retaliatory action against measures such as FDII, businesses in Germany are frustrated by the way its
government has so far responded to tax reform across OECD countries. ‘I think Germany is one of the very few countries now that has not announced anything in terms of reacting to the BEPS initiatives, reducing tax rates or simplifying the tax system,’ they said. ‘We’ve now seen huge US tax reform; almost all Western European countries have reduced or are reducing their tax rates and Germany’s not really doing anything. There are so many rules which go way beyond anti-abuse situations in Germany which make it increasingly difficult to recommend Germany as an investment location unless it mounts a response.’

In moving to a more territorial tax regime President Trump has brought the US closer to the way the rest of the OECD operates. But the compatibility of BEAT and FDII with what the US has agreed internationally could trigger some difficult conversations with the signatories to the BEPS Action Plan. We have already seen pressure applied by leading OECD members in relation to BEAT and FDII, and there may be more to follow. OECD members will be watching with interest to see how the US backs up its pledge to maintain co-operation in the future.

We’ve now seen huge US tax reform; almost all Western European countries have reduced or are reducing their tax rates and Germany’s not really doing anything.
Pressure points?
Addressing the unresolved questions of US tax reform

For some, the Tax Cuts and Jobs Act was wholly positive.
‘Today is a tremendous day in America,’ said Jay Timmons, President of the US National Association of Manufacturers, when the reforms were unveiled in November 2017. ‘The proposal is a guaranteed path to surge investment, jobs and economic growth.’

Others sounded a more cautious tone. The Alliance for Competitive Taxation – whose members include US oil producers, pharma companies and tech giants such as Google – welcomed the drop in the corporate rate and the move towards a territorial regime. However, they warned that other measures would need closer review ‘to better understand their impact on the global competitiveness of American workers and businesses’.

For a third group they were a disaster. The faster phasing out of federal tax credits for wind power – and the scrapping of state subsidies in their entirety for electric vehicles – sent shares in those industries tumbling.

As our interviews show, many foreign-based multinationals find themselves somewhere in the middle. And while the complexity of the reforms means their impact is hard to model, it is possible to draw up a list of common concerns among our research group.

1. Where will the US corporate rate end up in the long term?
2. Could the president’s trade war spill over into taxation?
3. What happens when the immediate expensing and interest deduction limitation provisions expire?
4. How far does BEAT really stretch, and is it here to stay?
5. How is the Treasury Department progressing with its ‘daunting task’ of drafting much-needed guidance for businesses?
The politics of long-term tax rates

The cut in the US corporate rate, bringing it much closer to parity with the majority of the OECD, was the most headline-grabbing measure in the reforms. Yet the longevity of the 21 per cent levy is the subject of much debate and will ultimately be determined by how US politics plays out over the next two years.

During the presidential campaign, Donald Trump had suggested he would drop the corporate rate to 15 per cent, arguing that this would make the US ‘highly competitive’ with other developed economies. While it eventually landed at 21 per cent for reasons already outlined, the president has since announced that he intends to push it down to 20 per cent, a move he believes will add a ‘great stimulus’ to the US economy.8

This second wave of reforms – which will be ‘even more aimed at the middle class’ – must be viewed in the context of November’s midterm elections. But if the Democrats regain control of either the House of Representatives or the Senate, further rate reductions are extremely unlikely. The Democrats have previously said they want to put the corporate rate up to 25 per cent. However, the lack of bipartisanship in US politics at present suggests they would need to win the presidency and majority control of both houses of Congress to make that a reality.

Future tax implications of ‘America First’

The reforms were designed to encourage investment in the US, but the president’s approach to trade is working in the opposite direction as it seeks to place tariffs on imports in order to reduce US trade deficits with, for example, China and EU member states.

President Trump hopes his tariff policy will ultimately help reduce the size of the trade deficit with China and the EU. But for businesses in the US that need raw materials such as imported steel and aluminium to make their products, this will only add to their costs and inhibit investment. His move to levy additional import duties on Chinese steel and raise tariffs on goods from the EU, Canada and Mexico has seen retaliatory charges applied to certain American exports.

This dynamic was blamed for the 7.8-point drop in CEOs’ plans for capital investment in the second quarter of 2018, revealed in the regular index from the Business Roundtable, an association of CEOs of large US corporations. In addition, 89 per cent of CEOs answering a question about the Trump administration’s approach to international trade issues, said it created a moderate or serious risk of lower US economic growth.

Joshua Bolten, President and CEO of the Business Roundtable

There is punishment coming out of Europe in the form of tariffs but that doesn’t mean it won’t spill over into tax.

Joshua Bolten, President and CEO of the Business Roundtable

So could the president’s protectionist policies eventually spill over into taxation? One of our interviewees thinks it’s a possibility. ‘There is punishment coming out of Europe in the form of tariffs but that doesn’t mean it won’t spill over into tax,’ they said. ‘The digital services tax in the EU is really a response to antitrust concerns related to the big US technology firms. So if tax is being used to tackle a competition problem then perhaps it could be used to tackle trade problems, too.’

When temporary provisions expire

The Tax Cuts and Jobs Act added a number of temporary provisions to the US tax code that are set to expire or change their terms over the next few
Four big questions on US tax reforms

This was done, at least in part, to help the bill pass through the Senate. Most of the provisions were relatively minor, but there are two that have potentially wide-reaching implications on business.

The first is the immediate expensing rule (also known as 100 per cent bonus depreciation). This allows for immediate and full expensing for certain property acquired and used after 27 September 2017 and before 2023. This provision is reduced by 20 per cent each year from 2023 until it expires in 2026.

This is a short timeframe for multinationals given the typical horizons in which strategic decisions are made. However, Deutsche Telekom’s Christian Dorenkamp believes the provision will live on in some form beyond its expiration date, and if so could be a ‘game changer’ for capital-intensive industries.

‘I don’t believe they will get rid of bonus depreciation completely,’ he said. ‘I think there will always be some special deductions for capex, otherwise US corporations would have to pay too much tax during the transition period.’

The second provision causing concern is the interest limitation rule. Now, businesses can only deduct the equivalent of 30 per cent of their EBITDA (earnings before interest, taxes, depreciation and amortisation) in interest payments on their corporate loans from their taxable income, and will be further restricted to 30 per cent of EBIT from 2022. This reduces the appeal of debt financing for US businesses and acquisitions as, previously, companies could deduct all of their interest payments from their taxable income. It will also add to borrowing costs in four years’ time for companies that make large annual deductions from their taxable income for depreciation and/or amortisation because interest deduction will be based on EBIT.

Kari Pahlman, Vice President of Global Tax for Techtronic, a Hong Kong-based tech company with substantial operations in Asia, Europe and the US, believes it is unlikely this provision will be changed or reversed. ‘It is following BEPS Action 4 and is similar to rules we see in other developed countries,’ he says.

Germany has restricted interest deductions for a number of years and the UK introduced a similar measure in 2017. The EU has now introduced a directive as well that requires all member states to impose that type of restriction.
Crafting international tax guidance to implement tax reform has been ‘a daunting task’ given the fundamental changes made to the US tax system.

Chip Harter, Deputy Assistant Secretary (International Tax Affairs), US Treasury
The future of BEAT

BEAT is the subject of the greatest negative sentiment among our interviewees. BEAT is an anti-avoidance measure that targets multinational groups with a significant US presence. It effectively applies a 10 per cent minimum tax for taxable income adjusted for certain types of payments made by US corporations to related non-US corporations.

Businesses want more certainty about the scope of BEAT and more detail about when a tax liability would arise under it. One interviewee said the treatment of different transfer pricing methods is unclear. ‘Groups may want to rethink their inbound transaction structures; they may consider converting payments into another form, embedding them in product transactions, or possibly changing their transfer pricing models altogether.’ He adds that no one is clear yet how much a company’s BEAT payments would go down if it changed its transfer pricing methods — for example, if it decided to keep more profit in the US.

It is not the only uncertainty about the BEAT. No one is clear either about whether intra-group payments for administrative services ought to be included when calculating BEAT liability or not. Some interpret the law differently, but groups need certainty on this. If keeping certain charges in the US will mean they will have to pay more BEAT, they may consider changing their policy to avoid this situation.

And a lack of clarity surrounds the validity of the BEAT itself because some aspects of the provision may be subject to challenge by the international community.

Carol Doran Klein, Vice President and International Tax Counsel at the US Council for International Business, believes it is possible to argue that the BEAT does not respect the arm’s length standard for transfer pricing, which is the internationally accepted principle in the OECD Model Tax Convention (the guidance underpinning the bilateral tax treaties of OECD members), or advance pricing agreements (APA). The arm’s length standard, which was designed to prevent groups from trading within the group at artificial prices, states that companies in the same group should trade goods and services with each other on the same terms as if they were dealing with their competitors. APAs are agreements, often lasting for five years, between tax authorities and companies about the prices they should charge their fellow group companies for goods and services. They are aimed to provide companies with certainty about the amount of tax they should pay on transactions between member companies of a group by ensuring that the correct amount of income is allocated to each jurisdiction because the proper price is charged between related parties.

‘One might argue that BEAT would violate those principles, because it doesn’t matter whether you have an APA or whether the payment is otherwise considered to be arm’s length, BEAT would effectively disallow a share of the deduction,’ she says. ‘However, the US government could argue that it’s no longer clear whether the internationally accepted standard should take into account the arm’s length nature of the payments, because Action 4 of the BEPS Action Plan concerning limitations on the deductibility of interest payments doesn’t actually rely on the arm’s length principle.’

A slog for the Treasury

The multinationals in our research are delaying making any significant investment or structuring decisions until they get more clarity from the US Treasury on how the new rules will be applied.

The Treasury’s intention is to release guidance on GILTI, BEAT and other international tax provisions introduced in the Tax Cuts and Jobs Act by the end of this year.

Chip Harter
Deputy Assistant Secretary (International Tax Affairs)

However, Chip Harter, who advises on international tax policy and tax treaties at the US Treasury, has said that crafting international tax guidance to implement tax reform has been ‘a daunting task’ given the fundamental changes made to the US tax system.

Harter told the 2018 OECD International Tax Conference in June that he has personally attended more than 200 meetings with businesses since the start of the year. With so much guidance to create, the Treasury is trying to prioritise those areas companies are most concerned about. The interaction between the GILTI provisions and expense allocations, and the application of BEAT to certain types of intra-group payments are at the top of the list.

Businesses will continue to play the game of ‘wait and see’ on a number of key areas of the US reforms. But there are some near certainties at least. Senate Democrats have made it clear that they would move the corporate rate up to 25 per cent if they won the midterm elections. They are also likely to retain some of the anti-avoidance measures such as the BEAT and the new interest limitation rules. However, as the Republican experience on healthcare has shown, bipartisanism in Congress on the big issues is not working, so the Democrats will likely need to control both houses and the presidency if they want to pass tax reform of their own.