NAVIGATING US TAX REFORM: What Businesses Need to Know

March 20, 2018
## Agenda

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Overview

Background:
• Prior reform efforts.
• Legislative process to the Tax Cuts and Jobs Act ("TCJA").

Domestic Provisions:
• Corporate rate cut.
• Limits on net operating loss ("NOL") deductions.
• Expensing of capital expenditures.
• Limits on interest deductions.

International Provisions:
• New territorial system.
• Transition tax ("mandatory repatriation").
DOMESTIC PROVISIONS
Navigating US Tax Reform: What Businesses Need to Know

Corporate Rate Cut Overview

In General:
• Federal rate cut from 35% marginal rate to flat 21% rate.
• Taxable years beginning after December 31, 2017.
• Permanent cut, unlike many other aspects of TCJA.

Implications:
• Increases in corporate cash flows.
  • Wages.
  • Capital investments.
  • Debt repurchases.
  • Stock repurchases and dividends.
• Increased relative competitiveness of U.S.-based business operations.
Corporate Rate Cut – Where Will it Go?

Possible Flows:

Exhibit 4: On Average, How Are Companies Likely to Allocate Their Tax Savings?

Source: Morgan Stanley
### NOL Deductions – Prior Law

**NOL Carryback Example**

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>300</td>
<td>(200)</td>
</tr>
<tr>
<td>NOL Carryback</td>
<td>(200)</td>
<td></td>
</tr>
<tr>
<td>Taxable Income</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>

- Allowed Corp in Year 2 to receive refund of $105 taxes paid in Year 1 (35% x $300).

**NOL Carryover Example**

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0</td>
<td>(200)</td>
<td>300</td>
</tr>
<tr>
<td>NOL Carryforward</td>
<td>0</td>
<td>0</td>
<td>(200)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
</tbody>
</table>

- Allowed Corp in Year 3 to reduce its taxable income to $100 and reduce tax from $105 to $35.
Limits on NOL Deductions

In General:
- Limits NOL deduction to 80 percent of taxable income.
- No NOL carrybacks.
- Repeals corporate AMT.

Implications:
- Removes prior “smoothing” aspects of NOL deductions and carrybacks.
- Heightened interaction with new international provisions.
- Accelerate “death spiral” of financially troubled corporations.
- May increase costs of leveraged acquisitions.
Expensing of Capital Expenditures

In General:
- Bonus depreciation percentage is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023.
- Phases down 20 percent per year through 2026.
- Applies to used property.

Implications:
- Increased purchases of eligible property.
- Increased “asset deal” M&A transactions.
### Expensing Examples

#### $100 Basis

<table>
<thead>
<tr>
<th>Regular Depreciation</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation %</td>
<td>20.00%</td>
<td>32.00%</td>
<td>19.20%</td>
<td>11.52%</td>
<td>11.52%</td>
<td>5.76%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>(20.00)</td>
<td>(32.00)</td>
<td>(19.20)</td>
<td>(11.52)</td>
<td>(11.52)</td>
<td>(5.76)</td>
<td>0.00</td>
</tr>
<tr>
<td>Other Income</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>80.00</td>
<td>68.00</td>
<td>80.80</td>
<td>88.48</td>
<td>88.48</td>
<td>94.24</td>
<td>100.00</td>
</tr>
</tbody>
</table>

#### $100 Basis

<table>
<thead>
<tr>
<th>Bonus Depreciation</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus Depreciation</td>
<td>(50.00)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation %</td>
<td>20.00%</td>
<td>32.00%</td>
<td>19.20%</td>
<td>11.52%</td>
<td>11.52%</td>
<td>5.76%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Depreciation Expenses</td>
<td>(10.00)</td>
<td>(16.00)</td>
<td>(9.60)</td>
<td>(5.76)</td>
<td>(5.76)</td>
<td>(2.88)</td>
<td>0.00</td>
</tr>
<tr>
<td>Total Depr. Expenses</td>
<td>(60.00)</td>
<td>(16.00)</td>
<td>(9.60)</td>
<td>(5.76)</td>
<td>(5.76)</td>
<td>(2.88)</td>
<td>0.00</td>
</tr>
<tr>
<td>Other Income</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>40.00</td>
<td>84.00</td>
<td>90.40</td>
<td>94.24</td>
<td>94.24</td>
<td>97.12</td>
<td>100.00</td>
</tr>
</tbody>
</table>

#### $100 Expensing

<table>
<thead>
<tr>
<th>Bonus Depreciation</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Expensing</td>
<td>(100.00)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Income</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>0.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>
Limits on Interest Deductions

In General:

- Interest deduction is limited to 30% of the corporation’s “adjusted taxable income” (taxable income without regard to interest and depreciation).
- In 2022, depreciation add-back goes away.
- Unlimited carryforwards.

Examples:

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(20)</td>
<td>(20)</td>
</tr>
<tr>
<td>Interest</td>
<td>(30)</td>
<td>(30)</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>(10)</td>
<td>(10)</td>
</tr>
<tr>
<td>Taxable Income before Limit</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Adjusted Taxable Income</td>
<td>90</td>
<td>70</td>
</tr>
<tr>
<td>x 30% = Maximum Interest Deduction</td>
<td>27</td>
<td>21</td>
</tr>
<tr>
<td>Taxable Income after Limit</td>
<td>43</td>
<td>49</td>
</tr>
</tbody>
</table>

Implications:

- Increased after-tax cost of leveraged structures.
- Increased use of alternative financing (leases, partnership structures).
Limits on Interest Deductions

Possible Impact by Sector:

Source: Goldman Sachs

*Utilities and Real Estate are not subject to 30% limit.
Corporations with EBITDA-to-interest ratios below 2x may suffer decreased funds from operations ("FFO"): 

Source: S&P Global Ratings
INTERNATIONAL PROVISIONS
**Historic Incentive for Deferral: The “Trapped Cash” Problem**

Former Worldwide Tax System:
- Domestic corporations generally were taxed on all income, whether derived in the United States or from abroad.
- Foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally was not subject to U.S. tax until the income was distributed as a dividend to the domestic corporation.
- Subject to anti-deferral rules of “subpart F” of the Code, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive income earned by its foreign subsidiaries.

**U.S. Parent**
- Cash needs.
- 35% tax on distributions from Foreign Sub (with allowance for foreign tax credit).

**Foreign Sub**
- Accumulated low-tax earnings.
- Not subject to U.S. 35% tax until distributed to U.S. Parent.
Who had the Cash?

By Sector:

- Info Tech: $633
- Health Care: $151
- Industrials: $60
- Consumer Staples: $35
- Cons. Discretionary: $25
- Financials: $6
- Energy: $6
- Materials: $4
- Telecom: $1
- Real Estate: $0
- Utilities: $0

*Source: Goldman Sachs*
Where (sort of) was the Cash?

U.S. Direct Investment:

Source: Goldman Sachs
Historic Deferral System

- Current tax at US corporate rates – e.g. 35%
- FTC under §960

- U.S. tax deferred until repatriated (or deemed repatriated under §956)
- FTC under §902 when repatriated
Example: Historic Netherlands Holding Company and Finance Structure

- NL Holdco lends excess cash to Foreign Sub 1.
- Foreign Sub 2’s excess cash distributed to NL Holdco.
Example: Historic Ireland IP Holding Company Structure

- Foreign OpCo pays Ireland IPCo a deductible royalty for the use of IP.
New Territorial System

In General:

• *Overview* – 100% deduction for dividends received from foreign subsidiaries in which U.S. parent owns 10% or more.
  • Foreign subsidiary’s earnings subject to local tax, but no U.S. tax when distributed to U.S. parent.
• *Transition Tax* – Accumulated earnings of foreign subsidiaries as of November 2 or December 31, 2017 subject to 8% U.S. tax on non-cash earnings and 15.5% U.S. tax on cash earnings (with similar haircuts for foreign tax credits).
  • “Forced repatriation.”
  • Payable over 8 years, with back-loaded installments.
• *GILTI Tax* – Foreign subsidiary’s earnings in excess of tangible return (10% x subsidiary’s depreciable asset basis) taxable to U.S. parent at 10.5% tax rate.
• *Export Incentive* – U.S. parent’s earnings from export sales in excess of tangible return (10% x parent’s depreciable asset basis) eligible for favorable U.S. tax rate of 13.125%.
New “Territorial” System

- Current tax at US corporate rate of 21%
- FTC under §960

- 100% DRD available for foreign source dividends - no U.S. tax (unless §956)
- No FTC

- Current US taxation at 10.5%
- 80% FTC
Example: Basic Territorial System with 100% Dividends Received Deduction

- **U.S. Parent**
  - $75 dividend not subject to U.S. tax

- **Foreign OpCo**
  - $100 local profit
  - ($25) local tax
Example: Global Intangible Low-Taxed Income ("GILTI") Minimum Tax in Territorial System

- Foreign IPCo’s GILTI = $100 local profit, less 10% x $20 depreciable asset basis = $98.
- U.S. Parent must include 50% of Foreign IPCo’s GILTI (i.e., $49) in its gross income, taxed at 21% = $10.29 tax.
Example: Foreign-Derived Intangible Income ("FDII") Export Incentive

- U.S. Parent’s FDII = $100 net income from export sales, less 10% x $20 depreciable asset basis = $98.
- Subject to 13.125% U.S. tax rate = $12.86 tax.
GILTI vs. FDII – The Big Picture

• **GILTI**
  - 10.5% GILTI rate for taxable years beginning after 12/31/17 and before 1/1/26
  - 13.125% GILTI rate for taxable years beginning after 12/31/25
  - Due to 80% limit on FTCs for GILTI per § 960(d), the minimum foreign tax rate at which no U.S. residual tax is owned is 13.125% (16.406% after 12/31/25)
  - As foreign taxes on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rates range between 10.5% and 13.125%

• **FDII**
  - Taxed at 13.125% for taxable years beginning after 12/31/17 and before 1/1/26
  - Taxed at 16.406% for taxable years beginning after 12/31/25
Navigating US Tax Reform: What Businesses Need to Know

New Worldwide U.S. “Tax Map”

- Assume 0% local tax.
- 10% tangible return not taxed.

- Expensing of tangible property exempts ~AFR%.

21% U.S. tax

10.5% U.S. tax

13.125% U.S. tax

Foreign Customers

U.S. Customers

U.S. Parent

Foreign Subco

Foreign Customers
Structuring Considerations for Multinationals

- Existing IP structures – what to do?
  - How strong is your subpart F position?
  - Is your current structure defensible from a OECD DEMPE standpoint?
  - Does the exposure to shifting international tax rules warrant maintaining foreign structure or is FDII a better course of action?
  - Is moving IP back to the U.S. feasible/can it be done in a tax efficient manner?
  - Is FDII reliable? Future congressional changes and/or WTO challenge?
Structuring Considerations for Multinationals

- Acquired and newly created IP – where to locate?
  - Impact of revisions to §§ 367(d) and 482
  - Strength of subpart F position(s)
  - Is your international structure defensible from a DEMPE standpoint?
  - Changing foreign tax laws a concern?

- Foreign branch operations?
  - Subject to standard 21% corporate rate
  - Onshore operations and pursue FDII?
  - Offshore assets and navigate subpart F and GILTI
Immediate Implications for U.S. Corporations

Currency Management:

• Increases inbound flows of FX to USD.
• Increase cross border flows through intercompany cash management systems.
• Increase currency hedging activity (and tax traps).
• Tax / treasury / legal coordination.
Base Erosion Anti-Abuse Tax

• Base erosion anti-abuse tax ("BEAT," Code Section 59A) equal to the excess of (a) 10 percent (five percent in taxable year beginning in calendar year 2018) of modified taxable income ("MTI") over (b) regular tax liability
  • Add one percentage point for banks and securities dealers
• Regular tax liability not reduced by research credit and 80 percent of certain other credits
• Effective for payments paid or accrued in taxable years beginning after 2017
Base Erosion Anti-Abuse Tax

- For taxable years beginning after 2025, 12.5 instead of 10 percent, credits reduce regular tax liability

- BEAT impactful when deductions from/reductions in gross income taken into account in computing taxable income, but not MTI, exceed 52.38 percent (40.47 percent after 2025) of MTI
  - *Cf.* old law Section 163(j)
What’s Next?

• Technical corrections bills.
• Guidance from Treasury and IRS.
• Impact of 2018 elections.
• Challenges from trading partners.
• Worldwide “race to the bottom.”
Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty  Astana  Beijing*  Boston  Brussels  Century City
Chicago  Dallas  Dubai  Frankfurt  Hartford  Hong Kong*
Houston  London  Los Angeles  Miami  Moscow  New York
Orange County  Paris  Philadelphia  Pittsburgh  Princeton  San Francisco
Shanghai*  Silicon Valley  Singapore  Tokyo  Washington, DC  Wilmington

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