Tax Reform ? Considerations for U.S. Multinationals

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Congress recently enacted comprehensive tax reform (the “Act”). This memorandum highlights some of the provisions of the Act that are particularly relevant to U.S. multinational groups, with a focus on the provisions relating to income associated with intangible property, as defined for applicable U.S. federal income tax purposes.

New Corporate Tax Rate

The Act significantly changes the U.S. corporate tax regime by reducing the nominal tax rate to 21 percent and introducing new limitations on tax attributes and preferences, such as interest expense deductions and net operating losses. The combination of the lower tax rate and interest expense limitation may (a) reduce the tax benefit to a multinational of allocating third party and intercompany debt to a U.S. borrower and (b) increase the use of preferred equity financings which have an advantage over debt in that dividends on preferred equity generate a higher after-tax return to investors than interest income on debt (this results from either a dividend-received deduction, in the case of corporate holders, or the preferential qualified dividend rate, in the case of non-corporate holders).

Quasi-Territorial Tax System

The Act adopts a quasi-territorial tax system under which dividends received by a U.S. corporation from a foreign subsidiary that is owned 10 percent or more by the U.S. parent will generally be exempt from U.S. tax. As part of the transition to the new system, a one-time toll charge (at a 15.5 percent tax rate for earnings held in cash and cash equivalents and an eight percent rate for other earnings) will be imposed on the undistributed earnings of foreign subsidiaries, as determined as of the end of 2017. These rules are intended to unlock existing offshore cash and to incentivize U.S. multinationals to repatriate offshore earnings in the future on a current basis.

GILTI

In order to prevent U.S. multinationals from offshoring intangible property to low-tax or tax haven jurisdictions, the Act includes a new tax (initially at an effective 10.5 percent tax rate and at a 13.125 percent rate starting in 2026) on global intangible low-tax income (“GILTI”) earned by foreign subsidiaries. GILTI is intended to capture a foreign subsidiary’s excess return from intangible property and is calculated based on the foreign subsidiary’s net income for the year (subject to certain exceptions) over a 10 percent return keyed off the subsidiary’s basis in its tangible assets. The GILTI rules provide for an 80 percent foreign tax credit against the GILTI tax. As a result, a foreign subsidiary organized in a jurisdiction with an effective tax rate of 13.125 percent (16.4 percent starting in 2026) or higher will generally not be subject to the GILTI tax.

FDII

The Act also includes an incentive for U.S. multinationals to hold their intangible property inside the U.S. by providing for a corporate deduction to reduce the effective U.S. tax rate on foreign-derived intangible income ("FDII"). FDII is generally the corporation's deemed intangible income (calculated based on a deemed 10 percent return on the corporation's basis in its tangible assets) that is derived from property sold, leased or licensed, or services provided to, unrelated foreign persons. The deduction is for 37.5 percent of FDII for years prior to 2026 and for 21.875 percent for taxable years thereafter (resulting in an initial effective tax rate of 13.125 percent and 16.4 percent starting in 2026).

BEAT

In order to prevent earnings stripping and other techniques to base erode U.S. taxable income, the Act imposes a new Base Erosion Anti-Abuse Tax ("BEAT"). BEAT is calculated based on a formula that generally results in a 10 percent minimum tax on a corporate taxpayer's income, as determined without taking into account deductible payments to a related foreign person (other than payments for cost of goods sold, certain payments for services at cost with no mark-up and certain derivative payments). There is significant uncertainty regarding the application of the BEAT rules. For example, under these rules, royalties paid to foreign affiliates would be subject to BEAT while payments for the purchase of products (which may include embedded intangible property) may not be subject to BEAT. In addition to BEAT, the Act broadens the Internal Revenue Service's ability to pursue alternative transfer pricing methods when valuing intangible property in outbound transfers and intercompany licensing transactions. The impact of the Act on intangible property transfer pricing methodologies is beyond the scope of this Alert.

Impact of the Act on Intangible Property Structures

Taken together, GILTI and FDII are intended to equalize the U.S. tax cost of holding intangible property in the U.S. and in other jurisdictions. Whether a U.S. multinational would achieve a lower effective tax rate by holding intangible property in the U.S. or abroad depends on a number of factors, including (i) the amount of tangible assets in U.S. and foreign operations for purposes of calculating GILTI and FDII, (ii) transfer pricing and withholding tax considerations, and (iii) the effective tax rate in the relevant foreign jurisdiction (*i.e.*, to the extent that U.S. multinationals are able to hold their intellectual property in a low-tax or tax haven jurisdictions there may still be a tax benefit in holding intangible property offshore to take advantage of the 10.5 percent tax rate on GILTI versus the effective 13.125 percent tax rate on FDII).

In addition to the reduced U.S. effective tax rate, the new transfer pricing policies and anti-base erosion BEAT rules will prevent the utilization of offshore intellectual property to generate U.S. tax deductions. Thus, for a U.S. multinational with intangible property that is utilized intragroup and is not licensed to third parties, the loss of a U.S. deduction combined with increased transfer pricing risk under the new rules may make pre-tax reform structures inefficient.

Multinationals considering changes to their structure as a result of the Act should take into account that there is substantial uncertainty regarding the interpretation of many provisions of the Act and that there is expected to be significant regulatory and administrative guidance which could impact the application of these rules to a particular taxpayer. Moreover, some of these rules, such as FDII, are expected to be challenged by non-U.S. trade organizations, such as the WTO.