This tax brief discusses those aspects of the US tax reform which have most relevance to Australian corporate and international taxation, both from a tax policy perspective and for inbound and outbound investment to and from the US.

The Tax Cuts and Jobs Act (its colloquial name) was signed into law on 22 December 2017 after a conference agreement was reached between the US Senate and House of Representatives on their differing tax reform bills. As the majority for the Republicans is very narrow in the Senate, the final Act tends to follow the Senate rather than the House version of the bills.

The tax brief discusses the details and some specific implications of the tax reform, with discussion of the broader issues at the end. The tax reform generally commenced on 1 January 2018, meaning little preparation time for most taxpayers. Ouch! And for those who actually planned for the new law, the US Treasury Secretary has power to make regulations to neuter tax planning.

Corporate and business income tax rates

The new corporate tax rate of 21%, unlike many other measures, is permanent in the sense of not having a current sunset. The complex procedural and budget rules about tax bills in the US Senate mean that other measures often have expiry dates or changes in the future. The new rate really means an average tax rate for companies in the US of around 25%, given the existence of corporate taxes at the state level. The dividend received deduction for dividends paid between US corporations has been adjusted to keep the current tax rates on such dividends roughly constant (10.5% generally, 7.35% for 20%+ participations, 0% for 80%+ participations).

For US based multinationals there will also be an additional tax on profits retained offshore discussed below which in the medium term will offset the tax cut in differing degrees. In Apple’s case alone this additional tax will amount to around USD 38 billion.

For individuals deriving business income effectively connected with a trade or business in the US (including through partnerships or trusts but not including accountants, lawyers and many other professional service providers), a 20% deduction is available. The deduction effectively lowers the top individual federal US tax rate for business income that it covers from (the new reduced top individual rate of) 37% to 29.7% but is subject to many complexities and expires at the end of 2025. The alternative minimum tax remains for individuals as do the top rates of 20% for long term capital gains and most dividends. The result is a composite top tax rate of 37% for income from shares (21% + [20% x 79% = ~16%]), which is not a coincidence.
Despite the changes to taxation of individual’s business income, the most obvious impact of the tax cuts from an individual’s perspective is the large gap that has now opened up between the corporate tax rate and the top individual rate, and even between the corporate tax rate and the reduced business income tax rate. Previously the high US corporate tax rate was near the top individual tax rate and the incentive was to move income out of corporations into transparent entities, especially as only individuals could benefit from the reduced long term capital gains tax rate. Now the incentive apparently is for high wealth individuals and families to move (back) into corporate structures to access the 21% tax rate.

But there is a twist. The US has an Accumulated Earnings Tax, the purpose of which according to the US Internal Revenue Manual is “to prevent a corporation from accumulating its earnings and profits beyond the reasonable needs of the business for the purpose of avoiding income taxes on its stockholders”. This tax has had little part to play recently in the US because of the rough equivalence of the top individual and corporate tax rates, but it may once more become an issue if large scale private incorporation were to occur in the US.

**Expensing of depreciating property**

For most property subject to depreciation, immediate expensing is available for acquisitions in the period 28 September 2017 to the end of 2022. Thereafter the additional tax benefits over normal depreciation for acquisitions decline by 20% per year. Depreciation is a complex issue in the US and the new law is no different.

One area of disagreement that was settled in the conference agreement is that the new rules apply to second hand as well as new property but the new rules will prevent transactions between related parties to exploit the change.

**Losses**

Tax losses incurred in years after 2017 can now be deducted only up to 80% of income. Effectively all such tax losses in the US now have an available fraction of 0.8! Previously tax losses were subject to a two year carry-back and a 20 year carry-forward. Under the new law there is no carry-back and indefinite carry-forward.

This will mean that profit projections for new investment in long-term projects in the US will often need to be modified and the limit on use of losses may, to some degree, blunt the attractiveness of expensing of depreciating property. It will also bring an end to the ability of buyers to effectively fund part of the purchase price by carrying back deductions incurred in relation to the transaction, claiming a refund for prior years and then paying that to the seller. Further the change detracts from the repeal of the Alternative Minimum Tax for corporations which has been hailed as one of the achievements of the reform.

**Carried interests in investment partnerships**

It is common in the US for persons providing services, especially investment advice, to an investment partnership to receive a carried interest in the property of the partnership under which the person shares in the profits on realisation of the partnership property. In the US the lower capital gains tax rates for individuals (including if received through partnerships or trusts) relate to long term capital gains defined as capital property held for more than one year. Carried interests under certain conditions obtain the same treatment even though they are effectively a payment for services.
The new law extends the holding period necessary for such a carried interest to be taxed at long term capital gains rates to three years. From an Australian perspective this change may mean that private equity and other investment managers may be reticent to look for early exits from investments. They will also be mindful of funding any bolt-on acquisitions from internal cash flow or third party borrowing rather than drawing down on equity commitments from limited partners, which could re-set the relevant acquisition date for at least part of the investment.

**Interest deductibility and the influence of BEPS in the US**

To this point the description of the US tax reform looks very US-centric, making changes to rules in areas that have long been US domestic tax reform battlegrounds and where the tide has ebbed and flowed. While the rules above have significant international investment ramifications, they largely play to a domestic US audience, including the many large corporates that are essentially US focused. The US rules on interest deductibility, and those that follow in this tax brief, bring in the international dimension as they mainly impact on cross-border economic activity, even though the interest rules are not explicitly limited to cross-border cases.

Moreover, the tax reform here takes on a decidedly BEPS-flavour, notwithstanding the general impression that the US (and especially the Republican party) was only lukewarm on the G20/OECD Base Erosion and Profit Shifting project under the former administration and is decidedly cold on international cooperation under the new administration. The new interest deductibility rules are almost entirely from the BEPS play-book on Action 4. They have a certain familiarity as they work by amendment of current US rules and use some similar concepts, though this also leads to some loose ends that do not fit together.

The new rules limit deductibility of business interest expense (net of business interest income) to 30% of tax EBITDA (2018-2021) and an even more stringent 30% of tax EBIT thereafter. The rules separate business interest income and expense from investment interest income and expense as the US has existing rules in the latter area. The rules apply separately to each corporation except where it is part of a US tax consolidated group in which case they are applied on a group basis. Detailed provisions deal with application of the new test to partnerships. Excess interest deductions may be carried forward without time limit.

The new rules do not require that the recipient of the interest be related to the payer and tax exempt or subject to low tax, nor do they contain a separate debt-to-equity test, unlike the previous rules. An additional cap on interest deductibility appearing in Senate and House bills disappeared in the conference agreement – it would also have applied a limit on deductibility based on world-wide interest expense allocated among countries based on EBITDA if that amount were lower.

Exceptions to the rules are provided for floorplan financing of motor vehicles, the property industry and taxpayers with a three year moving average of annual gross receipts not in excess of USD 25 million. Because the rules apply to interest as defined for US tax purposes, there may be an incentive to shift into leases for finance.

**Hybrid mismatch rules**

A similar adoption of BEPS thinking is apparent in relation to hybrids. With regard to hybrid instruments, the new participation exemption will not extend to dividends that have been deducted offshore (see below). With regard to hybrid entities, the US law does not take the form of repealing the US check-the-box rules which have been a significant source of hybrid entities tax planning, as is evident in a number of recent Australian tax cases. Rather it adopts the BEPS Action 2 work more or less completely, so far as can be told from the new law, in relation to deductions in the US for interest and royalties payments.
It will be recalled that Australia released an exposure draft and explanatory material on the BEPS Action 2 Final Report in late 2017 totalling 115 pages of very dense material which itself often calls in aid the 450 pages that the OECD released on the topic. This material does not yet include the further 100 pages of the OECD Report on Branch Mismatch Arrangements to which the Australian government is also committed. The US apparently has legislated both OECD reports so far as they affect deductions for interest and royalties in 1.5 pages of legislation and 1.5 pages of explanation which became public in November 2017 in the Senate bill and took effect on 1 January 2018 with no grandfathering of existing arrangements.

This dearth of detail – we get more out of an Australian Media Release on proposed changes to the law – means that tax professionals in the US will find giving advice in relation to deductions in hybrid mismatch situations very difficult as all of the detail is still to come in the form of US Treasury regulations. All that can usefully be said for now is that hybrid tax planning is a very high risk area for Australian businesses dealing with the US.

Participation exemption and repatriation tax

After many years of debate on the topic, the US has finally moved to a participation exemption for dividends though there is no equivalent in the US tax reform to exempt the profits of foreign branches of US corporations or capital gains on shares in foreign subsidiaries. Although creation of a participation exemption is not directly part of the BEPS agenda, it does bring the US into the international mainstream of using the exemption system for such dividends, along with the BEPS provisions designed to deal with various forms of tax planning involving participation exemptions. Hence, as mentioned above, the US, consistently with BEPS Action 2, denies the exemption to debt-equity hybrids giving rise to a deduction or other tax benefit for the dividend in the country of the payer.

The US exemption requires a US corporate shareholder to have a 10% vote or value participation in the foreign corporation held for at least 365 days consecutively around the dividend payment date and is available for holdings through interposed partnerships. (The same vote or value test has also been adopted for defining CFCs, in lieu of the former 10% voting test.) The rule operates, consistently with the treatment of domestic intercorporate dividends, as a dividend received deduction rather than an outright exemption but dividends benefiting from the deduction do not attract foreign tax credits for any withholding tax on the dividends. The indirect foreign tax credit for underlying corporate tax is also no longer available.

The exemption is only available to the extent the dividend is paid out of foreign source profits of the foreign company, which prevents some of the circular tax planning seen in recent cases with the Australian exemption. The cost of shares in foreign subsidiaries is reduced, for the purposes only of calculating a capital loss, by the amount of any exempt dividends (hence dealing with potential dividend stripping).

As is well known much of the concern about BEPS internationally was caused by tax planning of US multinationals ending up with huge amounts of profits stored offshore – estimated at USD 2.6 trillion for Fortune 500 companies – which could not be repatriated to the US without triggering large amounts of US tax under the previous foreign tax credit system.

As the introduction of a participation exemption without more would have turned the tax deferral on such earnings into an outright exemption, US proposals in this area have usually included a “repatriation tax” on offshore earnings as a transitional measure as if they had been repatriated just before the participation exemption took effect. The main debate has been about the tax rate to be applied, which to some extent has been tied to proposals made at the same time to cut the US corporate tax rate as the revenue raised would go some way to paying for the tax cut.
This compromise has played out as an income inclusion taxed at 15.5% for cash and equivalents (including publicly listed securities) and 8% for other amounts representing earnings and profits (a US tax concept) accumulated post-1986, being the date of the last significant US corporate tax reduction. A pro rata foreign tax credit is available for foreign taxes paid on the income. The tax can be paid in instalments over eight years without interest and with 60% of the amount back-loaded into the last three years.

As the complications of the calculation will be significant and there is concern about action having been taken in anticipation of such a tax to reduce its base, extensive regulations will be made to give effect to the tax. The IRS has already issued two notices providing guidance on its application, with more on the way.

US multinationals now risk being caught two ways as many of them are in dispute with foreign tax authorities including the ATO (and the European Commission under state aid cases which will still proceed despite the repatriation tax) as a result of past tax planning which gave rise to their low taxed offshore profits. On the other hand the prospect of the repatriation tax may have made the US multinationals more willing to settle up with foreign tax administrations.

Treatment of global intangible low-taxed income (GILTI) and foreign-derived intangible income (FDII)

The US has made some remarkable changes in the area of intangible income which have a subtlety not unlike BEPS in the hybrid mismatch area. For hybrids, BEPS proceeds in a number of areas by creating a primary response which allocates the additional revenue arising from removing the hybrid mismatch to a particular country (usually the country of the payer). Then if that country does not adopt the primary response, the other country involved invokes a defensive rule which removes the mismatch and gives it the revenue.

This approach seemed to anticipate that the US would take no action in relation to hybrid mismatches given the tax legislative gridlock in the US Congress before and during the BEPS process, so that if the primary response fell to the US and no action occurred, the other country could take the revenue. As seen above the US has now acted on hybrid mismatches.

BEPS in relation to intangible income took (probably not very effective) action in the transfer pricing area under Action 8 and additionally under Action 5 adopted the nexus approach to patent boxes so that R&D needed generally to be done in a country before a low tax rate could be applied to the income from the intangibles resulting from the R&D. European countries have quickly acted to largely bring their patent boxes into line. The US is clearly the main winner from the nexus approach as the most valuable R&D is largely done in the US though the foreign returns to that R&D had been shifted outside the US by the tech giants.

The US has now for tax purposes in effect brought home the returns to its R&D and at the same time created its own patent box to keep the R&D in the US while leaving some tax incentive for US multinationals to strip the tax base of other countries. The mechanisms to achieve these results are complex but in brief, GILTI derived by CFCs of US shareholders is now included in income of the shareholders (but not under the US CFC regime) and then a tax deduction of 50% of GILTI is given to US domestic corporate shareholders with credit for foreign taxes on the income reduced to 80%, and with no carryovers of excess credits to other years. Moreover GILTI is subject to its own foreign tax credit limit separate from other income (including CFC inclusions) so that averaging with foreign tax on other income is not possible.

Combined with a 21% US corporate tax rate, the effective tax rate on GILTI is 10.5% after the deduction if no foreign tax is paid but if foreign tax is paid the combined US and foreign tax rate rises to 13.125% (or higher if the foreign tax rate is higher). Where foreign taxes on GILTI exceed 21% US
multinationals may be better off changing structures so the income is taxed directly or under the CFC regime. Many oddities in the GILTI regime are being identified on a daily basis.

FDII earned directly by US domestic corporations attracts a 37.5% deduction which equates to an effective tax rate of 13.125% with full credit for foreign tax up to that amount. In both cases these rates hold until the end of 2025 when the effective tax rate increases (as the deductions decrease then but maintain the relativities between GILTI and FDII).

In both cases intangible income is not defined directly but as a residual. Relevant net business income is isolated and the intangible element of that income is the excess over 10% of the adjusted tax cost of tangible depreciating property used to produce the income. GILTI is applied to CFCs and automatically is foreign income with income effectively connected to a business in the US excluded as well as income directly attributable under the CFC regime. FDII is applied to domestic corporations’ sales to foreign parties for use outside the US but does not include CFC attributed income, GILTI or business income of a foreign branch of the taxpayer. In other words, the FDII deduction applies to income from exports of goods and services. The effect of this definition of intangible income and the differing operations of the GILTI and FDII regimes seems to create a perverse incentive for US multinationals to locate tangible depreciating assets offshore rather than onshore, which contradicts the basic thrust of the US tax reform of increasing investment in the US.

The effect of these measures is current US tax on future income earned offshore by US multinationals whether held offshore or repatriated to the US where the income does not rely substantially on foreign depreciating tangible assets. In other words the tax planning that allowed the tech giants to avoid virtually all tax on their offshore earnings has been dealt with for the past through the repatriation tax and for the future by GILTI and FDII.

These measures are attracting criticism on a number of grounds. US Treasury has publicly maintained GILTI’s consistency with the nexus test in BEPS Action 5 though some in the private sector have a different view. And there is also the issue whether the FDII regime amounts to a subsidy in the form of a tax concession to US firms who sell to foreigners. The US has already lost three times to the EU in international trade law litigation over previous income tax regimes subsidising exports, and the EU has publicly signalled they take the same view of FDII.

Taxing rights over returns to intangibles due to the digitalisation of the economy is also again on the international tax agenda as the prime item of business for 2018, and the goalposts may shift again. A discussion paper will be released in association with the G20/OECD finance ministers meeting on 18 April. The UK has already announced action on this front in November 2017.

Transfer pricing changes

There have been some amendments to transfer pricing of transfers of intangibles but they mainly seem confirmatory of 2015 temporary regulations which are due to expire in 2018; indeed the legislation provides that the new rules are not to be taken to suggest that the law prior to 2018 was different. The changes provide power to make regulations to the effect that valuation of such a transfer should be done on an aggregated basis to capture synergies arising from transfer of bundles of intangibles or on the basis of the realistic alternatives (jargon for adjusting the terms of the transaction) if that supplies the most reliable valuation. The conference report seems to suggest that the regulations will reverse the losses suffered by the IRS in some recent court cases but this view has been doubted.

The BEPS Actions 8-10 Final Report also revised the transfer pricing guidelines extensively both for intangibles and more generally in relation to aggregation and options realistically available at about the same time as the US 2015 regulations, so it is likely that this is another provision designed to confirm conformity of the US with BEPS outcomes.
Base erosion and anti-abuse tax (BEAT)

The US now has its own version of a DPT in the form of an excise tax, the BEAT, on payments by a resident, or non-resident engaged in trade or business in the US, to related non-residents. The BEAT operates as a minimum tax and is levied on the payer on the difference between the payer’s income after elimination of deductions relating to the payments and its income including the deductions, with some adjustments for tax credits available to the payer.

The BEAT rate is 5% in 2018, 10% in 2019-2025 and 12.5% on a slightly different tax base from 2026 on. The BEAT rate for banks and securities dealers is 1% higher. In effect the relevant deductions are clawed back at a lower tax rate or to put it another way, the non-resident recipient is indirectly taxed even if a tax treaty would prevent or reduce the direct levy of an income tax on the recipient because, for example, it does not have a permanent establishment in the US.

The deductions covered relate to payments that are immediately deductible or give rise to tax depreciation or amortisation. By differing means there are exceptions for payments for inventory, derivatives accounted for on a mark to market basis and payments for services which are priced on a cost recovery basis without mark-up. This produces a significant difference for payments for inventory compared to services as the tax seems to apply to the whole payment if there is a mark-up for services. If US income tax is otherwise paid on the outbound payment (such as interest or royalty withholding tax), the payment is wholly or partly excluded from the BEAT depending on whether there is a treaty reduction of the US withholding tax and the extent of the reduction.

The BEAT is intended only for very large taxpayers, as with Australia’s DPT, and also for significant base erosion. The tax has a threshold for the payer of average annual gross receipts of USD 500 million and of base eroding payments exceeding 3% of deductible payments for the year. The BEAT is coordinated with the limitation on interest deductibility discussed above by assuming that interest allowed as a deduction under that limit is first allocated to payments to unrelated parties, thus reducing the base erosion amount subject to the BEAT. There is a regulation-making power to deal with attempts to avoid the BEAT through unrelated conduits and the like.

Comments

At the macro level the US tax reform impacts differentially on inbound and outbound investors, compared to US focused businesses of US companies like the large US retailers. As a generalisation, the combination of the lower corporate tax rate and expensing of depreciable tangible property gives the greatest tax benefit to the latter. Outbound investors from the US are potentially impacted by the repatriation tax and the GILTI/FDII regimes and inbound investors will be subject to the BEAT, meaning that their effective US federal tax rate may be significantly above 21%. Outbound investors with large repatriation tax liabilities may not notice much of a change in their tax liabilities in the medium term. Many of the large US tech companies will be affected, but not so much Amazon which announced a tax benefit of USD 789 million as a consequence of the changes. While Amazon has mostly made losses on its international operations, its North American operations have been profitable so Amazon was able to adjust its liability for future tax in response to the lowered US corporate tax rate. All businesses will be affected by the changes to interest deductions and hybrid mismatches, which will significantly reduce tax planning possibilities in relation to financing of investment.

The outcome is that while the US economic growth rate is likely to be boosted in the medium term, the growth may be driven by US focused companies and not by inbound and outbound investment. The IMF has forecast that the US growth rate will increase to 2022 and then start to decline which also suggests that the growth to the US economy will be coming from the bring forward of investment in tangible property because of the expensing of investment rather than the impact of the cut in the corporate tax rate – an analysis which the Australian audience has not fully appreciated.
This is a more complex picture than has been painted in Australia where the proponents of a cut in the corporate tax rate claim that international capital will be attracted away from Australia and into the US. The allocation of international capital will as much be driven by the reactions of other countries (and US states) to US federal tax reform. It is not yet clear what those reactions will be. In this regard the speed of the US reform where all of the real action took place within a few months after the debate in the first half of 2017 on the destination based cash flow tax ended means that it may be some time before all the reactions occur. This is in contrast to the 1986 US tax reform which was more than two years in the making and even then it was only in 1988 that Australia reacted with a corporate tax reduction.

The other issue that requires thought concerns how durable this tax reform will be. The 1986 reform was bipartisan and long debated, yet was partially undone within five years with a modest increase in the corporate tax rate and higher increases in individual tax rates along with more base broadening. Although there is some clawback of revenue foregone by the corporate tax rate cut from base broadening measures in the 2017 tax reform, the general consensus is that it will substantially increase the US deficit and will do nothing to halt increasing inequality in the US. The next elections in the US are in November 2018 which could see majorities change in either or both houses of the US Congress.

Another potential source of instability comes from outside the US. The OECD and G20 are looking seriously at taxes in relation to the digital economy in the country of the user. It is highly likely that new taxes will eventuate and that will put particular pressure on the US tech giants which have not fared all that well in the US tax reform.

At the micro level, taxpayers around the world with investments in the US need to scramble to adjust to the many tax changes which are already in effect. That may take some time to bed down. The account above only covers major changes but even apparently minor changes such as the reversal of a recent court decision having to do with partnerships is creating significant practical problems. It is not only tax that has to be considered but also financial accounting through the impact of the reform on tax-effect accounting. Already considerable red ink is appearing in the US on this score.

The IRS and US Treasury are also in scramble mode to come up with short-term guidance and to start longer term regulation writing projects. Whatever happens down the track with the US reform, it is going to take some time for the dust to settle.
These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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