Morgan Lewis

NAVIGATING US TAX REFORM:

WHAT BUSINESSES NEED TO KNOW

How Tax Reform will Impact the Auto Industry

March 6, 2018

Presenters:

Peter M. Daub, *Partner*
Michael Liu, *Partner*
Sarah-Jane Morin, *Of Counsel*
Jason Traue, *Partner*

AGENDA

UNDERSTANDING THE NEW BEAT TAX

BEAT - General Rules

- Base erosion anti-abuse tax ("BEAT") imposes tax on an **applicable taxpayer** equal to the base erosion minimum tax amount ("BEMTA"), calculated as equal to the excess of
  - (1) 10% (5% for 2018, 12.5% beginning after 2025) of modified taxable income ("**MTI**") over
  - (b) regular tax liability ("**RTL"**) net of certain credits
- MTI is generally taxable income increased by adding back deductions for payments to and depreciation and amortization for property acquired from **foreign related persons** and reductions in and deductions from gross re-insurance premiums paid to such persons
- Applies to domestic corporations and foreign corporations with effectively connected income (ECI), regardless of whether such corporations are part of a U.S.-owned or a foreign-owned group
- In addition to regular tax liability
  - cannot be offset by credits
  - not creditable in future against regular tax liability
- Effective for payments paid or accrued in taxable years beginning after 2017

Who is Subject to BEAT: "Applicable Taxpayer"

- BEAT applies only to an "applicable taxpayer," defined as a corporation with
  - generally more than a *de minimis* amount (3%) of the add-backs to taxable income in computing MTI as a percentage of the sum of all such-add backs and other deductions for the year (referred to as the "base erosion percentage," defined more precisely below)
- Exceptions applied on annual basis and computed on a group basis
  - "Single employer" aggregation
  - Applicable taxpayer can be a domestic or foreign corporation with ECI
  - Gross receipts of foreign corporations included only to the extent included in computing ECI

What Constitutes Modified Taxable Income

- 10% of MTI must exceed RTL net of certain credits for BEAT to apply; thus MTI is a key component
  - the larger the MTI, the greater the likelihood that BEAT applies
- MTI is defined as "taxable income" of the applicable taxpayer for the taxable year, **adding back**
  - (1) base erosion tax benefits -- "base erosion payments" that given rise in current year to allowable deductions or certain reductions in gross income or gross receipts for the year
    - Added back even if no current year benefit (because loss without regard to the base erosion payments), **and**
  - (2) the "base erosion percentage" of any NOL deduction
  - Note, if applicable taxpayer's taxable income is reduced more than 52% by base erosion payments, BEAT may impose additional tax.

Base Erosion Payments

- **Base erosion payment includes**
  - "any amount paid or accrued by the taxpayer to foreign person that is a related party" for which a deduction is otherwise currently allowed
    - For example, payments for rents, royalties, services, captive insurance
    - Includes interest payments as well
      - Interest for which deductions deferred under 163(j) stacked first to interest paid to unrelated persons
    - Foreign tax treatment irrelevant
    - Inclusion in Subpart F income or GILTI irrelevant
    - Treatment as ECI irrelevant
  - Depreciation/amortization deductions with respect to property acquired by taxpayer from a related person with an "amount paid or accrued" by the taxpayer to the related foreign person (*e.g.*, machinery, intangibles acquired by purchase)
  - Reductions in income for re-insurance premiums paid to related foreign person

Exclusions from Base Erosion Payment

- **Exceptions for**
  - Cost of goods sold on payments to related foreign persons
  - Amounts to the extent U.S. tax withheld on base erosion payment
    - If reduced withholding tax applies (e.g. treaty), only the percentage of the total amount subject to withholding is excluded

Certain Services

- **Exception for amounts paid for certain cost method services**
  - An amount paid or accrued for services if
    - (a) services meet requirements for eligibility of the services cost method (without regard to requirement that services not contribute significantly to fundamental risks of business success or failure) and
    - (b) amount constitutes total services cost with no markup component
  - Based on statute and legislative history may be possible to bifurcate service fees into cost and mark-up components, with BEAT applying only to markup component
    - Recent articles and legislative staff reach varying conclusions
  - Future guidance will be needed to resolve this important issue

Base Erosion Percentage

- Important in determining whether the 3% *de minimis* exception from the definition of an applicable taxpayer applies and the amount of any NOL deduction that is added back in computing MTI
- **Base erosion percentage determined by dividing**
  - Aggregate amount of base erosion tax benefits (as defined above, generally base erosion payments that give rise to deduction or reduction of gross income or gross receipts) for the taxable year, by
  - The sum of the aggregate amount of all deductions for the taxable year,
    - taking into account base erosion tax benefits (including reductions of gross income/receipts)
    - but not taking into account any deduction for amounts that qualify for exceptions for services and exclusion of COGS
  - Note, no exclusion from numerator or denominator of payments subject to U.S. tax due to, e.g., ECI, GILTI, Subpart F

Regular Tax Liability

- Regular tax liability must be reduced by most credits (including FTC) ("reducing credits"), thereby making the BEAT's application more likely
  - But until 2026 RTL not reduced by research credit For taxable years beginning after 2025, credits reduce RTL **in full**, thereby increasing the likelihood of the tax applying

- Note, to the extent that credits reduce RTL the greater the likelihood that 10% of MTI will exceed the RTL net of reducing credits and thus that BEAT will apply
  - if credits reduce RTL by more than 52%, BEAT is highly likely to apply, because RTL net of reducing credits reduced below 10% of MTI

Impact of NOL Deductions

- In calculating MTI, the base erosion percentage of any NOL deduction allowed under section 172 for the taxable year is added back
  - This provision raises a number of important issues, such as:
    - whether the base erosion percentage is determined by reference to the current year in which the NOL deduction is taken or the year(s) in which the NOL was created
    - whether pre-2018 NOL deductions are included even though BEAT did not apply in those years
  - Note, BEAT provisions provide for no special transition rule for NOLs

Other Distinctions

- US-distributor that buys products where the intangible is bundled into the cost of the product from a foreign related person is not subject to BEAT because of the COGS exception
  - But a US-distributor that licenses intangibles from a foreign related person to distribute products is, unless the royalty payments constitute COGS
- If a foreign group forms a Canadian subsidiary to purchase machinery, equipment and intangibles from foreign related persons and make and sell products into the U.S. through a U.S. related party distributor, BEAT does not apply to any of the payments made by the Canadian subsidiary as it is a foreign corporation (assuming no PE)
  - But if the same foreign group forms a U.S. subsidiary in Michigan to conduct the same activities, the payments to related persons by the U.S. subsidiary are subject to BEAT, unless the payments constitute COGS
- A foreign group that centralizes third party borrowing outside the U.S. and on-lends to U.S. subsidiaries that makes interest payments that are otherwise not denied under section 163(j) is subject to BEAT
  - But interest paid by a U.S. subsidiary of a foreign group that borrows from a third party with a foreign parent guarantee is not (although any amount paid for the guarantee would be)
- Many other similar situations

Planning Considerations

- Reduce amount of deductible payment by avoiding deductible payments
  - Plan into COGS exception
    - Purchase finished product from foreign affiliate (perhaps acting as contract manufacturer for foreign affiliate) rather than license intangibles owned by foreign affiliate and manufacture
  - Analyze all related party payments to determine if a change can be made to categorizing certain of these payments as inventoriable items
    - E.g., determine if services fee paid to contract manufacturer or other (or fees from other service arrangements) can be included in inventoriable costs

Planning Considerations

- Related to unrelated
  - Third party borrowing/license (with parent guaranty) rather than back-to-back borrowing/licenses from foreign parent
  - Pay unrelated parties directly rather than include in cost that it pays to related foreign person
- Reduce amount of deductible payments through netting
  - Cross-licenses?
  - Net amounts generally

Cautionary Concerns

- Regulations to "prevent the avoidance of the purposes" of the BEAT through:
  - "the use of unrelated persons, conduit transactions, or other intermediaries"
  - arrangements designed, "in whole or in part"
  - "to characterize payments otherwise subject to" the BEAT "as payments not subject to" the BEAT
  - "to substitute payments not subject to" the BEAT for "payments otherwise subject to" the BEAT
- What is the scope of these anti-abuse rules in particular situations, such as treatment of NOLs (and current year losses), distinction between deduction for royalties and exclusion of COGS including an intangible element, no allowance for netting or look-thru to unrelated party payments, and distinctions between various structures (*e.g.*, use of a foreign subsidiary rather than U.S. subsidiary to purchase equipment, machinery and intangibles from related parties and sell into the U.S.)

FDII & GILTI

FDII & GILTI deductions in § 250

- New § 250 combines two kinds of tax relief for a U.S. domestic corporation:
  - a <u>deduction</u> depending on its "foreign derived intangible income"
  - a <u>deduction</u> depending on the corporation's GILTI income inclusion
    - However, the deduction for GILTI is in some ways relief in "disguise". New § 951A (GILTI) establishes what is effectively a new category of subpart F income $\Rightarrow$ nominally taxed at 21 percent (ignoring creditable foreign taxes)
- New § 250 arose in the Senate, and is quite similar to Prop. § 250 from the 2014 Camp H.R. 1 (different GILTI-type deduction).

FDII & GILTI deductions in § 250

<u>§ 250 mechanics</u>

- New § 250(a)(1) provides that a domestic corporation shall be allowed as a <u>deduction</u> for each of 8 taxable years beginning after 12-31-17 and before 1-01-26 an amount—

  37½% × corporation's *foreign derived intangible income* ("***FDII***")

  \+ 50% × {corporation's § 951A GILTI inclusion

  \+ corporation's § 78 gross up attributable to GILTI}

- For taxable years beginning after 12-31-25 the percentages <u>drop</u>: 37½% → 21⅞%, and 50% → 37½%

FDII & GILTI deductions in § 250

- FDII is an approximation to the domestic corporation’s taxable income from exploiting intangible property outside the U.S.:

$$\text{FDII} = \text{deemed intangible income} \times \frac{\text{foreign-derived deduction eligible income}}{\text{deduction eligible income}}$$

$$= (\text{deduction eligible income} - 10\% \times \text{QBAI}) \times \frac{\text{foreign-derived deduction eligible income}}{\text{deduction eligible income}}$$

$\Rightarrow$ FDII amount turns on definition of *deduction eligible income*.

FDII & GILTI deductions in § 250

deduction eligible income = gross income – exceptions – allocable deductions

- There are 6 *exceptions*:

§ 951 subpart income	Dividends received from CFCs
GILTI	Domestic oil & gas extraction income
§ 904(d)(2)(D) financial services income	§ 904(d)(2)(J) foreign branch income

- FDII deduction increases if *foreign derived intangible income* increases.
  - § 250 has many rules to prevent “artificial” increases in FDII (including, e.g., round tripping) ↔ *cf*. no “foreign” qualification for GILTI.

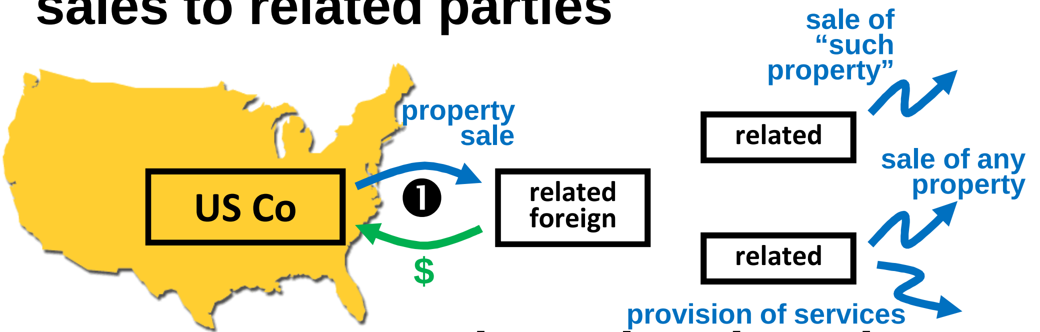
FDII & GILTI deductions in § 250

- *Foreign-derived deduction eligible income* is *deduction eligible income* derived in connection with:
  - **Property** "sold" by corporation to any person who's <u>not</u> a U.S. person <u>and</u> <u>provided</u> the Secretary is satisfied the property is for foreign use; &
  - **Services** provided by the corporation, <u>provided</u> the Secretary is satisfied they're provided to any person, or w/r/t property, not in the U.S.
- "**Use**" means use, consumption, or disposition.
- "**Sold**" includes transfer through lease, license, exchange, or other disposition.

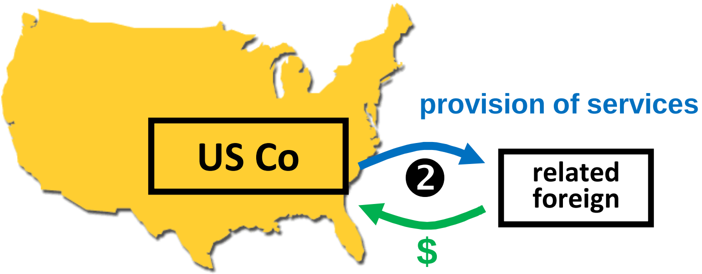
FDII & GILTI deductions in § 250

§ 250—special rules for related party transactions

- **sales to related parties**



- **services provided to related parties**



Income from ❶ can qualify if:

- "Such property" is ultimately sold for foreign use by a related party;
- "Such property" is <u>used by</u> a related party "in connection with"
  - sale of (any) property, or
  - provision of services,

  to a foreign, unrelated person.

Income from ❷ <u>can't</u> qualify unless such services are <u>not</u> substantially similar to services provided by such related party to persons within the U.S.

GILTI – The Stick

- **New Sections 951A and 250**
  - Section 951A effectively imposes a minimum tax on "US shareholders" of CFCs to the extent of such CFCs' global intangible low taxed income ("GILTI").
  - Similar to the FDII provisions there is no requirement to actually trace or attribute the income to the exploitation of intangibles owned by the CFCs.
  - At a very high level the GILTI income is generally the income of the CFCs less a deemed return (10%) on tangible assets.
  - Section 250 contains a companion provision that provides for a 50% deduction for the amount of the GILTI inclusions (and Section 78 deemed dividend associated therewith) subject to certain limitations. The 50% deduction is reduced to 37.5% for taxable years beginning after December 31, 2025.

GILTI – The Stick

- **Section 951A - Formula**

GILTI = Net CFC Tested Income – [(10% x QBAI)- Interest Expense]

- **Net CFC Tested Income** = aggregate of tested income of each CFC less aggregate tested losses of each CFC.
  - Tested Income = Gross income of the CFC (other than ECI, Subpart F income, Section 954(b)(4) high tax income, related person dividends, certain oil and gas income) less allocable deductions
  - Tested Loss = where allocable deductions exceed Tested Income of the CFC

- **QBAI** = Qualified Business Asset Investment or, generally, the average of the adjusted basis (using straight line) of specified depreciable tangible property determined as of the close of each quarter.

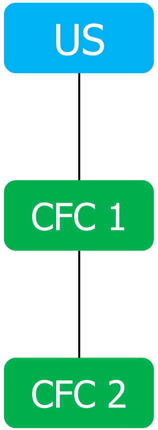
GILTI – The Stick

- **<u>Section 951A – High Tax Income</u>**

- 2014 Camp Bill – Under the Camp Bill, foreign base company intangible income (the original iteration of GILTI) was only subpart F income to the extent that the income was subject to a foreign effective tax rate lower than the effective U.S. tax rate imposed after taking into account the deduction for foreign intangible income.
- Under TCJA only Section 954(b)(4) high tax income is excluded. Relevant Section 954 regulations provide that the general Section 954(b)(4) high tax exception only applies if the taxpayer affirmatively elects for it to apply.
- Given that GILTI is an aggregate concept (in relation to the US Shareholder's CFCs), cross crediting is allowed. In other words, foreign tax credits a higher taxed CFC may be used to effectively lower the tax rate on GILTI income of lower tax CFCs.

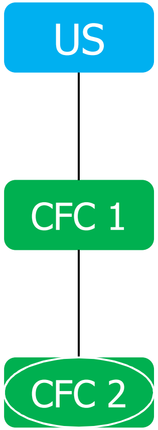
GILTI – The Stick

- **<u>Section 951A – Tested Loss</u>**



Tested Income - 100
QBAI - 0
FT - 5

Tested Loss - 5
QBAI - 100
FT - 10



Tested Income - 95
QBAI - 100
FT - 15

GILTI – The Stick

- **<u>Observations</u>**
  - When comparing the GILTI inclusions to FDII, Congress has apparently provided taxpayers with an incentive to locate investment offshore. This is because the deemed return on tangible property reduces the GILTI inclusion (thereby effectively reducing the amount of offshore income subject to US tax). Under the FDII rules, the deemed return on tangible property reduces the amount of income subject to lower tax rates on FDII.
    - To increase their returns on tangible assets, companies could consider acquiring the offshore independent contractors that conduct their manufacturing. This strategy may not work for companies that do significant product development in the U.S.
  - If the US Shareholder is otherwise in a loss position, the amount of the Section 250 deduction is reduced.

Comparing FDII and GILTI

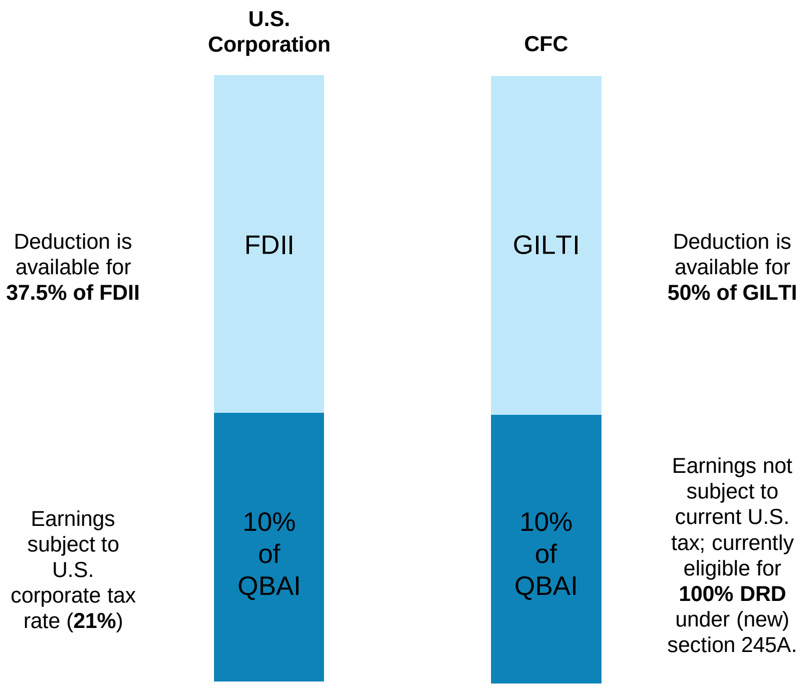
As noted, the calculation for both FDII and GILTI adopt the same tangible asset base – 10% of QBAI.

However, the treatment of income represented by that base differs under the two proposed regimes:

- FDII – subject to 21% corporation tax rate
- GILTI – eligible for 100% DRD under section 245A

The taxation of GILTI and FDII also differs:

- FDII – 37.5% deduction available
- GILTI – 50% deduction available

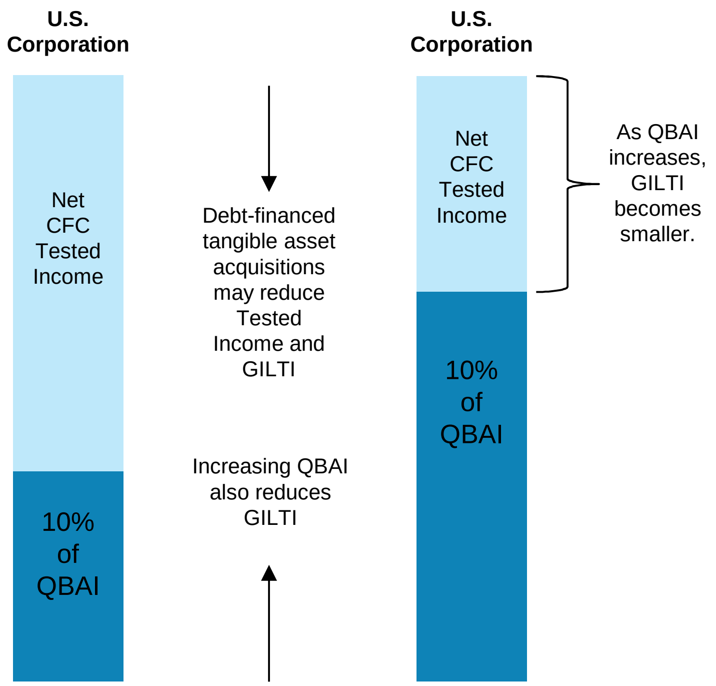


Managing GILTI and Optimizing QBAI

Increasing tangible assets held by CFCs (QBAI) effectively reduces the amount of income subject to GILTI taxation (assuming certain anti-abuse provisions do not apply).

Third-party debt financing can be used to:

- Maximize the amount of tangible assets held by a CFC, which in turn increases QBAI
- Reduce Tested Income through interest expense deductions (subject to certain proposed interest expense limitations under section 163)
- However, QBAI reduced to the extent of corresponding interest income is not taken into account as Net Tested Income (i.e., intercompany financing)



Anti-Abuse Provisions

- Section 951A(d)(4) authorizes the Secretary to issue regulations to prevent the avoidance of the purpose of section 951A, including guidance on the treatment of:
  - Property that is transferred or held temporarily (i.e., transitory transfers)
  - The transfer or holding of property where the avoidance of the purpose of section 951A is a "factor"
- In addition, general anti-abuse rules and provisions presumably continue to apply as well (e.g., section 7701(o), section 269, substance over form principles, etc.)
- *Observations*
  - The anti-abuse rule under section 951A(d)(4) is incredibly broad, applying if the avoidance of the purpose of the section is merely a "factor" in the transfer or possession or holding of property (i.e., an unusually low standard)
  - Arrangements and initiatives that pre-date section 951A (as published in the Senate bill) are likely on better footing vis-à-vis the anti-abuse rule
  - In addition, common / ordinary commercial arrangements and transactions, particularly those routinely entered into between unrelated parties, are also likely to fare better under the anti-abuse rule
    - Actual third-party arrangements may also provide useful comparables for purposes of establishing the transfer pricing for intercompany arrangements

LIMITATION ON DEDUCTION OF BUSINESS INTEREST

Old Code Section 163(j) repealed

- The prior version of Section 163(j), which limited deductions for interest paid to a related party, has been repealed
- Presently unclear how carryforwards of interest deductions disallowed under old Section 163(j) should be treated in 2018 and later years

New Code Section 163(j) limits deductibility of business interest

- Generally limits the deduction for business interest to the sum of:
  - Business interest income
  - 30% of "adjusted taxable income," and
  - "Floor plan financing interest"
- "Adjusted taxable income" approximates
  - For 2018-2021, EBITDA
  - For 2022 and later, EBIT
- "Floor plan financing interest" is defined as interest paid or accrued on debt
  - Used to finance the acquisition of motor vehicles held for sale or lease, and
  - Secured by the inventory so acquired

New Code Section 163(j) limits deductibility of business interest (continued)

- Businesses with average annual gross receipts of $25 million or less are generally exempt
- Disallowed business interest can be carried forward indefinitely
- Real property trades or businesses can generally elect out
- No grandfathering – limitation applies to existing debt

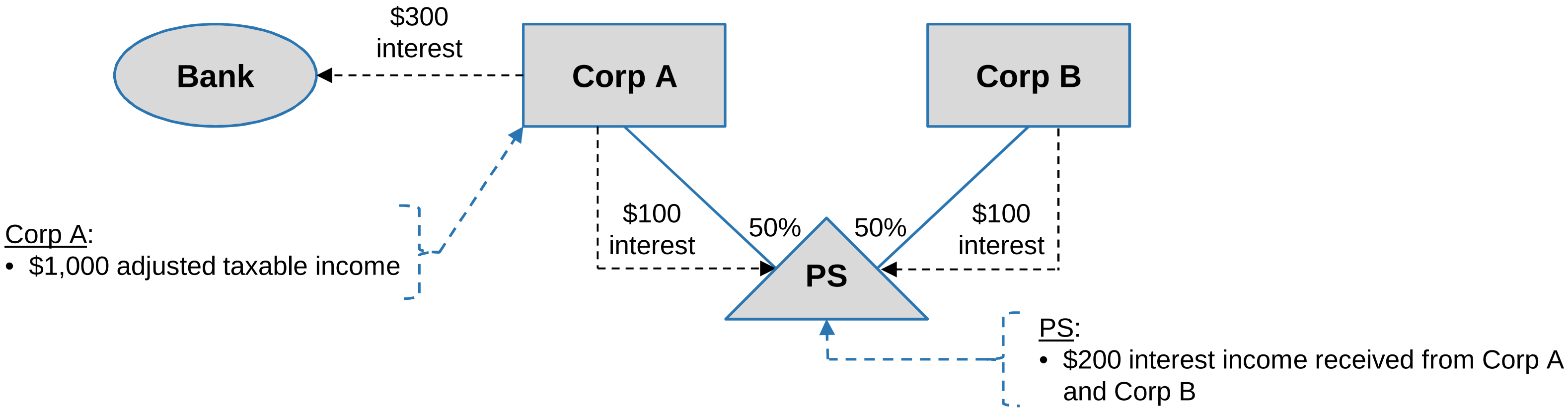
Practical observations

- For entities with significant depreciation and amortization deductions, business interest deductions may be sharply limited beginning with 2022 due to switch from EBITDA to EBIT "adjusted taxable income" base
- Entities without significant depreciation and amortization may feel effects sooner
- Immediate expensing before 2022 may mitigate, so planning capital expenditures is warranted
- May affect after-tax financing costs for LBOs and leveraged recapitalizations
- May encourage alternative transaction structures, such as sale-leasebacks or preferred partnership equity financings, where a buyer could replace interest with deductible rent or a "synthetic" deduction via a partnership allocation of income
- May encourage multinational groups to move debt to foreign subsidiaries
- Effect of limit will obviously vary depending on interest rates

Application to Pass-Through Entities

- Former section 163(j) used aggregate principles to apply interest deduction limitations to corporate partners.
- New section 163(j) adopts an entity approach:
  - If a partnership's business interest exceeds 30% of its ATI, the excess business interest is treated as a nondeductible expense that is allocated to the partners currently.
  - If a partnership's business interest is less than 30% of its ATI, partners may use their shares of the "excess" ATI in computing their deduction for business interest incurred outside of the partnership.
  - Otherwise, partnership income is not taken into account in computing partners' ATI.

Application to Pass-Through Entities: Example



Background:

- PS derived $2,000 of income in Year 1, but covenants to third parties (e.g., debt, leases) restricted it from making distributions to its partners. Instead, at the end of Year 1, PS loaned $1,000 to each of its partners, at 10% interest.
- In Year 2, PS derived $200 of interest from its partners and no other income.
- Also in Year 2, Corp A derived $1,000 of adjusted taxable income ("ATI") and paid $300 of interest to an unrelated Bank.

Application of Section 163(j) to Corp A in Year 2:

- If PS's interest income is treated as ATI, Corp A will receive an allocation of $100 of "excess taxable income" that will increase its ATI, but Corp A will be permitted to deduct only $330 of $400 of its interest paid (($1,000 adjusted taxable income + $100 excess taxable income) x 30%)).

Immediate expensing of certain assets

- Section 168(k) temporarily allows immediate 100% expensing of "qualified property"
- "Qualified property" generally includes
  - depreciable tangible property
  - NOT stock, real estate or intangibles
- Assets need not be new
- Incentivizes asset purchases—actual and deemed
- 100% expensing if placed in service after 9/27/2017 and before 1/1/2023
- Percentage steps down from 2023 to 2027, as shown on next slide

Expensing schedule—based on placed-in-service date

Placed in service	Expensing
9/27/2017-12/31/2022	100%
2023	80%
2024	60%
2025	40%
2026	20%

QUESTIONS ?

A recording of this presentation will be made available on our [Tax Reform resource page], a centralized, cross-practice resource for tax reform-related thought leadership and programs, including webinars, LawFlashes, blog posts, and more.

THANK YOU

Biography

Peter M. Daub
Washington, DC
T +1.202.739.5171
F +1.202.739.3001

With more than 30 years of experience, Peter M. Daub concentrates his practice in the areas of international and domestic tax planning for US- and foreign-based multinationals, financial institutions, and financial intermediaries. Domestically, he helps US-based multinational clients in deferral and repatriation structures and foreign tax credit planning and provides tax advice on financial and currency transactions. For foreign-based multinationals, Peter's principal areas of concentration include the structuring of US operations, withholding tax minimization, and enhancement of US tax treaty benefits. He has counseled a wide range of clients on withholding, including on Foreign Account Tax Compliance Act issues.

Biography

Michael Liu
Chicago/Silicon Valley
michael.liu@morganlewis.com
T +1.312.324.1498
F +1.312.324.1001

Michael Liu advises multinational corporations with domestic and international tax planning. His clients span a variety of industries, including those in the high technology, semiconductor, software, pharmaceuticals, and biotechnology sectors.

Michael advises private and public companies on a wide range of issues, including redomiciliations and redomestications matters; tax-efficient cash repatriation strategies; post-acquisition integration planning and implementation; cross-border merger and acquisition transactions; and loss utilization planning.

Biography

Sarah-Jane Morin
San Francisco
sarah-jane.morin@morganlewis.com
T +1.415.442.1231
F +1.415.442.1001

Sarah-Jane Morin focuses her practice on representation of public and private companies, private equity funds, venture capital funds, real estate funds, portfolio companies, and real estate investment trusts in the tax aspects of complex business transactions and fund formations, including domestic and cross-border investment strategies, sponsor investment strategies, limited partner investment strategies, mergers, acquisitions, integrations, buyouts, recapitalizations, debt and equity restructurings, and ongoing operations and tax compliance issues. Additionally, she advises on international tax issues, including the tax aspects of offshore vehicles (CFC/PFIC regimes), anti-deferral rules (Subpart F), withholding, cost sharing, and transfer pricing.

Biography

Jason P. Traue
Boston
jason.traue@morganlewis.com
T +1.617.951.8964
F +1.617.428.6410

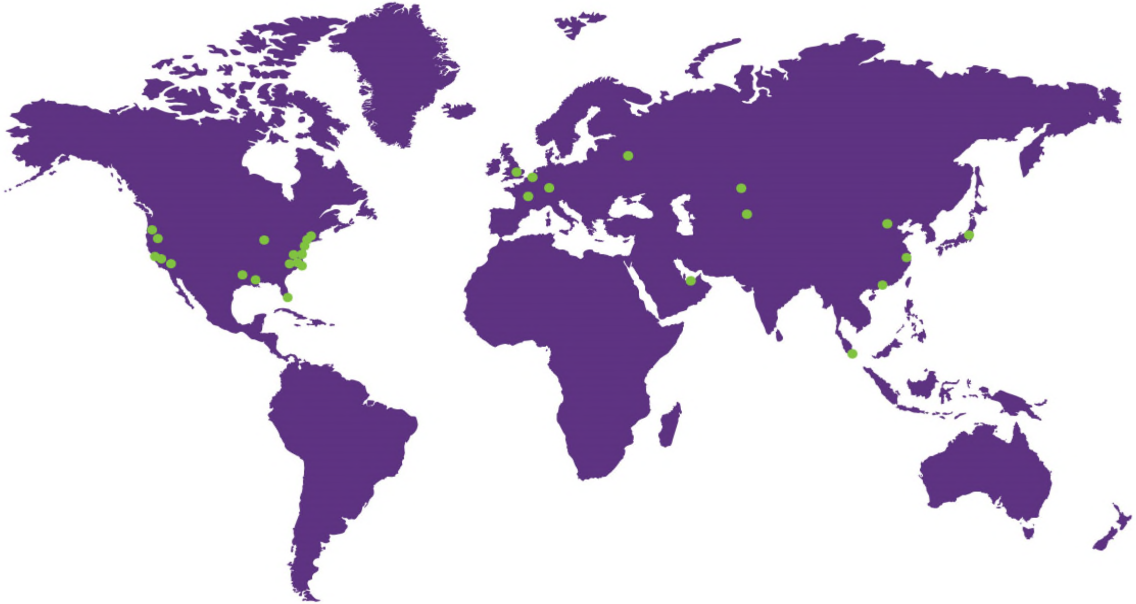
Jason P. Traue's practice focuses on federal tax matters. He works extensively with tax issues related to the formation and operation of registered and private investment funds. Jason also assists with merger and acquisition transactions, capital markets transactions, general corporate and partnership tax issues, and international tax issues. Jason has helped clients obtain numerous administrative rulings from the Internal Revenue Service and has assisted in federal and state tax controversy matters.

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



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners.