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NAVIGATING US TAX REFORM:

WHAT BUSINESSES NEED TO KNOW

Inbound Investment: Non-U.S. Taxpayers Investing Into the U.S. Market

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AGENDA

- Overview: Fundamental changes to corporate and pass-through taxation (D. Nelson)
- Required withholding on sales of partnership interests (W. Zimmerman)
- Limitation on deduction of business interest (D. Nelson)
- Limitation on deduction of net operating losses (D. Nelson)
- Immediate expensing (R. Zarin)
- Limitation on deductions for hybrid payments (R. Zarin)
- BEAT: Base Erosion and Anti-Abuse Tax (R. Zarin)
- Synthesis: Combined effect of new rules on blocker structures and U.S. corporate subsidiaries (D. Nelson, R. Zarin)
- Special Considerations for Inbound Real Estate Investments, Including REIT Structures (W. Zimmerman, R. LaFalce)

SECTION 01

OVERVIEW

Overview – Fundamental Changes to Corporate and Pass-Through Taxation

- Certain key changes to basic corporate tax treatment
  - Reduction in corporate income tax rate from 35% to 21%
  - Limitations on deductibility of business interest
  - Limitations on use of NOLs
  - Enhanced cost recovery through "expensing" of certain assets
- Key change to basic tax treatment of income from pass-through entities -- Deduction of up to 20% for "qualified business income" allocated to non-corporate partners
  - Formula limitations on amount of deduction
  - "Specified service" businesses excluded
  - Benefit applies to ordinary REIT dividends, which may spur increased use of REITs in real estate structures
- Takeaway – choice of entity considerations have changed
  - Difference in total tax burden in corporate structures vs. flow-through structures has diminished
  - New modeling will be needed to determine after-tax economic consequences of a corporate investment structure

Overview – Some important features of U.S. tax law relevant to non-U.S. investors did not change

- No changes to the "portfolio interest" exemption
- No changes to FIRPTA
  - Recently enacted exemption for "qualified foreign pension funds" unchanged
- No changes to Section 892
- Takeaway – the core ECI / FIRPTA / Section 892 planning considerations, and constraints, still remain relevant, but the economic consequences of different inbound investment strategies have changed

SECTION 02

REQUIRED WITHHOLDING ON SALES OF PARTNERSHIP INTERESTS

Non-U.S. partners subject to withholding and tax on sale of ECI partnership interests

- Reverses a recent Tax Court case, *Grecian Magnesite*, and reflects long-standing IRS position.
- Taxable gain reflects, in general terms, portion of gain that would be viewed as tied to a US business if the partnership sold its assets.
- Significant change is addition of an obligation to withhold at 10% of the foreign seller's entire "amount realized" for a buyer of such a partnership interest, and a backstop obligation of the partnership to withhold from distributions to a buyer who does not so withhold.
- "Amount realized" for purposes of determining amount to be withheld presumably includes seller's deemed share of partnership liabilities, which is difficult to determine as of time of sale.

Non-U.S. partners subject to withholding and tax on sale of ECI partnership interests (continued)

- IRS has temporarily suspended this withholding for publicly traded partnerships.

- Subject to regulations or other guidance, withholding applies to transfers that are otherwise tax-free.

- No stated exceptions based on limited amount of potential ECI—that is, subject to regulatory guidance, no exceptions along the lines of the 50%/90% exception to withholding provided for transfer of partnership interests reflecting in part US real property interests.

SECTION 03

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, and
  - 30% of "adjustable taxable income."
- "Adjusted taxable income" approximates
  - For 2018-2021, EBITDA, and
  - For 2022 and later, EBIT.
- Limitation based on fixed percentage of EBITDA is consistent with OECD BEPS recommendations.

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

- Businesses with average annual gross receipts of $25M or less (indexed to inflation) are generally exempt
- Disallowed business interest can be carried forward indefinitely
- Real property trades or businesses can generally elect out

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
  - No grandfathering—this is an issue that needs to be considered as to existing instruments
  - Immediate expensing before 2022 may mitigate, so planning capital expenditures is warranted

SECTION 04

LIMITATION ON DEDUCTION OF NET OPERATING LOSSES

Limitation on Deduction of Net Operating Losses

- For NOLs arising in tax years ending January 1, 2018 and after, NOLs may generally only be carried forward, and carryforward period is now indefinite.
- NOL deduction for losses arising in tax years beginning after 2017 is limited to 80% of taxable income.
  - This will have an impact on decisions regarding the amount of internal leverage to employ in inbound investment structures and the degree to which immediate expensing is desirable, if the combination of those deductions would create an NOL
- 80% limit does not apply to NOLs arising prior to 2018
- Corporate AMT (and associated 90% limitation on NOLs for AMT purposes) has been repealed

SECTION 05

IMMEDIATE EXPENSING

Immediate expensing of certain assets

- Code Section 168(k) temporarily allows immediate 100% expensing of "qualified property"
- "Qualified property" generally includes
  - depreciable tangible property
    - stock, real estate, and intangibles are not "qualified property"
- Incentivizes acquisitions of qualified property in the next decade
- 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

9/27/2017-12/31/2022

100%

2023

80%

2024

60%

2025

40%

2026

20%

SECTION 06

LIMITATION ON DEDUCTIONS FOR HYBRID PAYMENTS

Limitation on Deductions for Hybrid Payments

- For tax years that begin after December 31, 2017, no deduction allowed for interest or royalties paid to a "hybrid" (i.e., tax transparent for U.S. purposes, but not for foreign purposes) related party or that is a "hybrid" payment (i.e., treated as interest or royalties for U.S. tax purposes, but not for non-U.S. tax purposes) to the extent that there is no corresponding inclusion (or a deduction is allowed) to the related party under that party's resident country tax law.
  - This limitation will require non-U.S. investors and non-U.S. multinationals to carefully evaluate the U.S. tax classification of their non-U.S. holding company structures to ensure that interest deductions on shareholder loans are not inadvertently limited

SECTION 06

BEAT: BASE EROSION AND ANTI-ABUSE TAX

Base Erosion and Anti-Abuse Tax

- For tax years that begin after December 31, 2017, certain very large corporations will have to pay a “minimum tax amount” equal to approximately 5% in 2018 and 10% thereafter (increasing to 12.5% in 2025) of their “modified taxable income”,
  - “Modified taxable income” is a corporation’s income without taking “base erosion payments” (generally, any deductible amount paid to a related foreign party) into account.
- Applies only to corporations with average annual gross receipts of at least $500 million (measured over a three-year period)
  - Thus, may have limited impact except in the case of larger multinationals

SECTION 06

SYNTHESIS: COMBINED EFFECT OF NEW RULES ON BLOCKER STRUCTURES AND U.S. CORPORATE SUBSIDIARIES

Synthesis: Combined effect of new rules on blocker structures and U.S. corporate subsidiaries

- U.S. "blocker" corporations are often used to shield non-U.S. investors from direct U.S. tax filing and payment obligations with respect to investments in tax transparent entities that conduct U.S. businesses or that hold U.S. real estate.
  - Similarly, non-U.S. parents of multinational groups often establish U.S. corporate subsidiaries to conduct their U.S. operations, rather than operate through a U.S. branch
- Such U.S. corporations may be capitalized in part with loans made by their non-U.S. shareholders. The new tax law's restrictions on business interest deductions, as well as potential for BEAT tax and limits on deductions for hybrid payments, may reduce the corporate-level tax benefits of such leverage.
- Leverage may still be of interest with respect to non-U.S. shareholders as a means to allow repatriation of free cash flow without U.S. withholding tax (subject to the shareholders' eligibility of investors for the portfolio interest exemption or tax treaty benefits).

Synthesis: Combined effect of new rules on blocker structures and U.S. corporate subsidiaries (continued)

- The U.S. corporate tax leakage will be reduced, going forward, because of the new 21% federal corporate tax rate (versus the prior 35% maximum rate), as well as the potential for enhanced expensing and other tax benefits.
- Expansion of rules regarding determination of whether a foreign corporation is a controlled foreign corporation, or CFC, may result in foreign corporations that do not have significant U.S. direct or indirect ownership being classified as CFCs.
- IRS has provided relief from U.S. tax reporting (IRS Form 5471) when a foreign corporation becomes a CFC solely because of constructive ownership under the new rules.
- Expanded CFC definition still may include many foreign corporations not previously subject to these rules, e.g., where there is at least one direct or indirect U.S. owner, by either vote or value.

SECTION 07

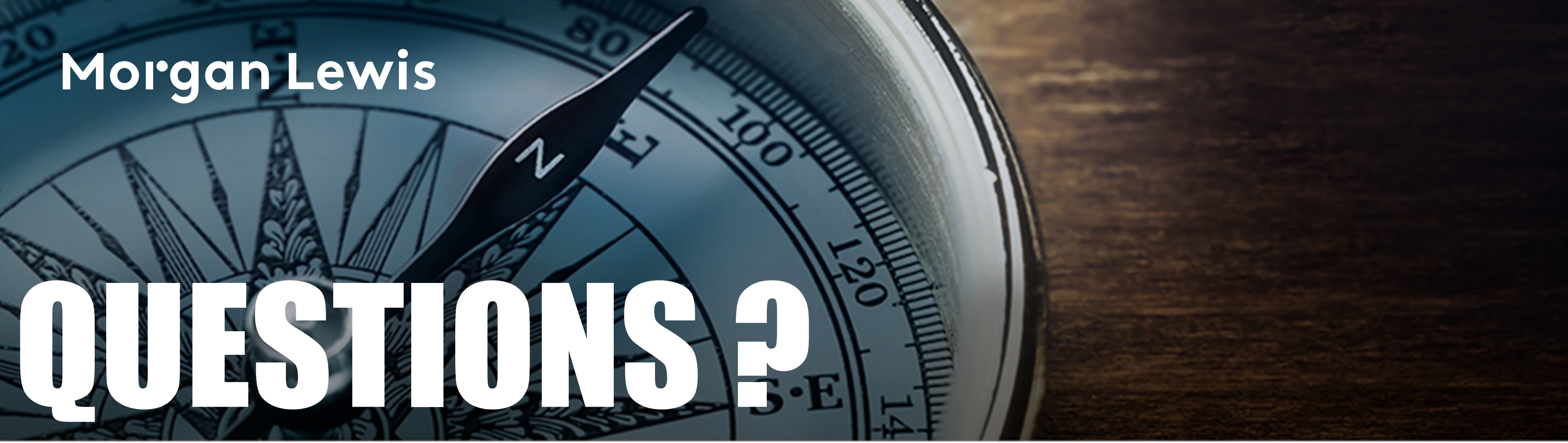
SPECIAL CONSIDERATIONS FOR INBOUND REAL ESTATE INVESTMENTS, INCLUDING REIT STRUCTURES

New Code Section 199A: Non-Corporate U.S. Taxpayers Receive 20% Deduction for REIT Ordinary Dividends

- The new 20% deduction is available for "qualified REIT dividends" received by U.S. taxpayers other than corporations
  - The term "qualified REIT dividends" includes ordinary REIT dividends, but excludes:
    - Capital gain dividends, and
    - Dividends designated as "qualified dividend income"
- This new benefit, coupled with other benefits that REITs can provide for U.S. taxpayers, may result in increased use of REITs in U.S. real estate investment structures

Other features of new law that benefit inbound real estate investments

- Reduction of basic corporate rate to 21%, which would benefit existing levered "C corporation" blocker structures as well as new corporate structures
- Ability to elect out of the limitation on "business interest" deductions
- Repeal of former Section 163(j) limitations on deduction of interest paid to related parties
- Retention of Section 1031 for tax-deferred like kind exchanges of real estate
  - Section 1031 like kind exchange treatment no longer available for other asset classes



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THANK YOU

Biography

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Richard C. LaFalce counsels clients on the creation and taxation of private and pooled investment vehicles such as mutual funds, REITs, ETFs, hedge funds, and other investment-related entities. He frequently advises clients on the taxation of financial products, general corporate and international tax matters, and UBIT. Before joining Morgan Lewis, Rich was an assistant branch chief in the Internal Revenue Service Office of Chief Counsel, Financial Institutions and Products.

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Daniel A. Nelson advises clients on the US and international tax and commercial considerations related to the efficient structuring of transactions and business relationships. He counsels global institutional investors—including investment managers for some of the world's largest pension funds, sovereign wealth funds, and insurance companies—in connection with investments in real estate, infrastructure projects, and other real assets. Dan also advises sponsors regarding the formation and operation of customized investment platforms, private investment funds, and joint ventures involving pension funds, sovereign wealth funds, insurance companies, and other institutional investors.

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Richard S. Zarin provides tax advice to sponsors of and investors in a wide range of onshore and offshore investment funds. In addition, working with businesses in industries such as financial services, aviation, education, media and shipping, Richard S. Zarin counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning.

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William P. Zimmerman guides clients on the creation and operation of private and pooled investment vehicles, such as mutual funds, hedge funds, real estate investment trusts, and other investment-related vehicles. He also advises clients on general corporate and individual tax planning matters, including reorganizations, mergers, acquisitions, spinoffs, recapitalizations, and workouts. Additionally, Bill provides partnerships and limited liability companies with planning and operational guidance on tax-related issues.

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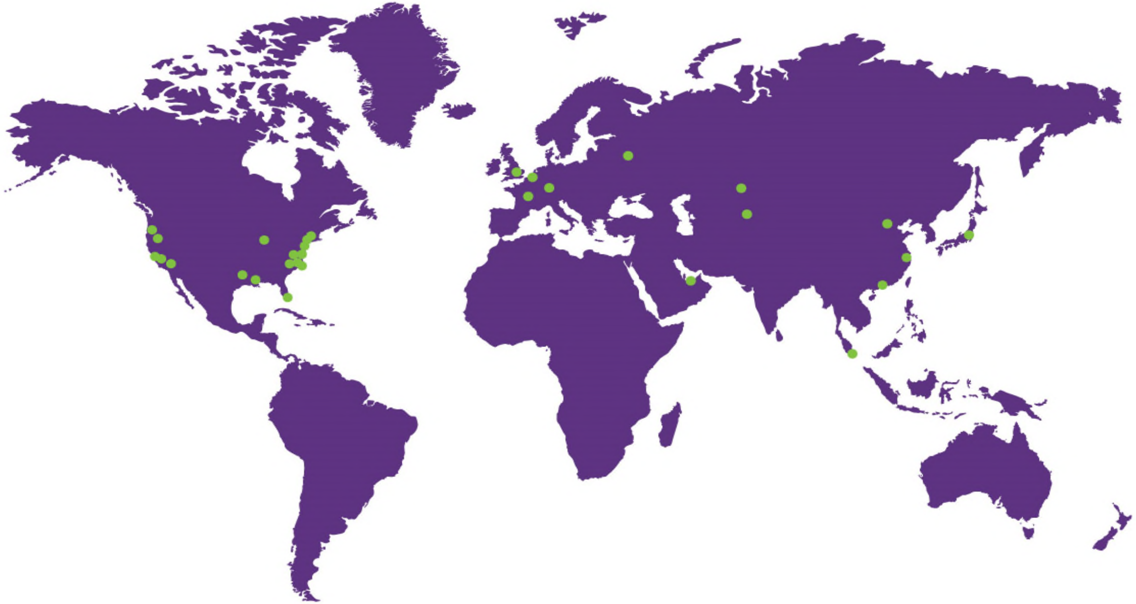

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