

US Tax Reform – Context, New Tax Concepts and Impact on Your Business Models

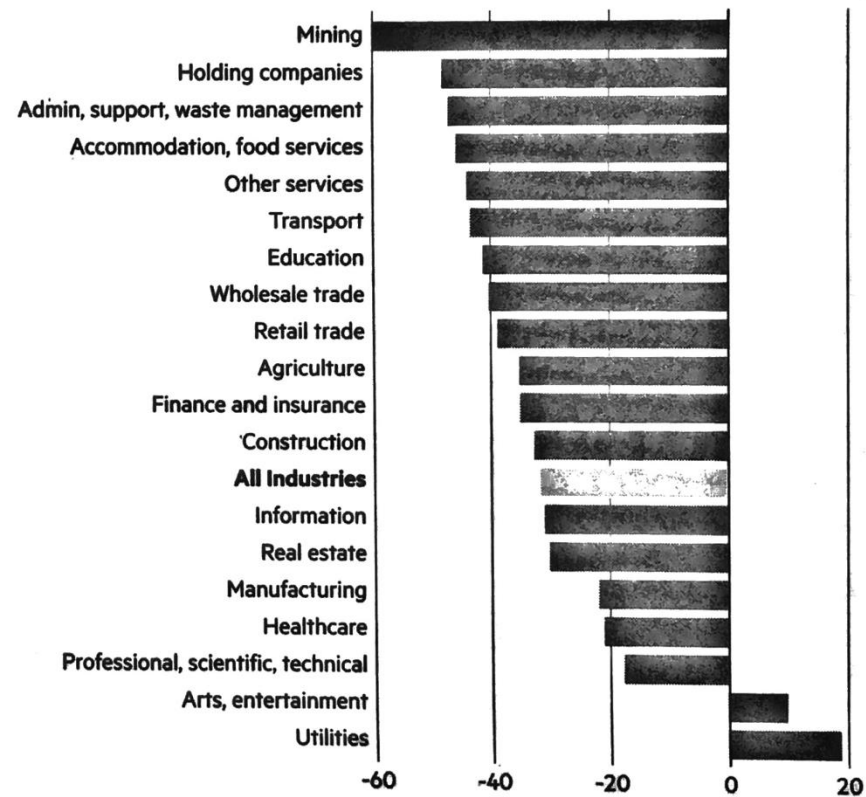
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Amsterdam

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 - Deductions for FDII and GILTI
 - Base Erosion Anti-Avoidance Tax (“BEAT”)
- Impact of tax reform on business models
- Practical implications

1. Setting the scene

Corporate winners and losers from the Republican tax bill

Change in expected tax paid between 2018 and 2027, by industry (%)



Source: Financial Times, 21 December 2017

2. One-off I (Repatriation savings)

Apple in line for \$47bn tax windfall under Republican bill

- New legislation sees liability slashed
- Rate on repatriated cash to be halved

Jerusalem Warnings mount
recognises divided city as Is:



- Apple will see up to \$47bn slashed from its expected tax liability, making it the biggest beneficiary of the new US legislation
- Taxing repatriated profits at no more than 14,5%, irrespective, whether or not it is returned home cash wise
- Apple has \$252bn in foreign cash and investments
- Apple has previously indicated in its accounts that it plans to bring back only half its foreign cash hoard. However, executives have made little secret of their hope of repatriating much more, probably for use in stock buybacks.

Source: Financial Times, 7 December 2017

2. One-off II (Level playing field – insurance companies)

Finance groups face \$50bn tax hit

◆ Republican plan set to dent US majors ◆ Prospect of taxpayer funding makes a comeback

Source: Financial Times, 19 December 2017

- 5 finance institutions that endured huge losses in the financial crisis would be forced to take write downs totalling almost \$50bn if the planned US tax rewrite passes, denting profits at Citi-group and forcing taxpayers to inject new funds into Fannie Mae and Freddie Mac.
- Under current tax laws, some of the biggest names in corporate America, have been able to cut their tax bills significantly because they can use past losses to offset future profits.
- Industry executives and analysts estimate Citi would need to take a hit approaching \$16bn, AIG about \$6.5bn and BofA \$3bn.

3. ETR 1960-2016 - History



Source: Financial Times, 29 November 2017



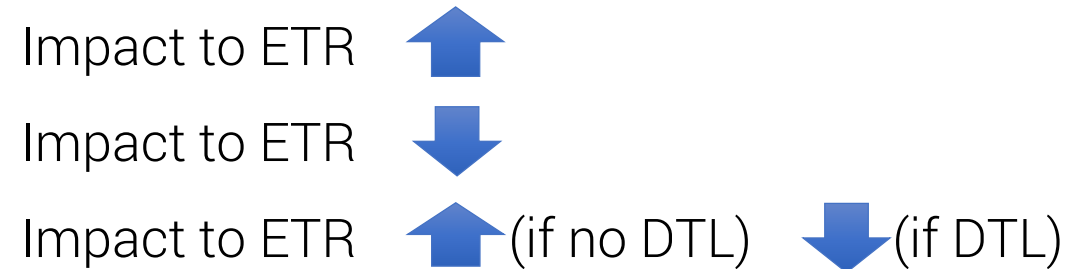
Source: Financial Times, 20 December 2017

- Foreign-owned insurers say the tax on cross-border flows of insurance cash will make it harder for them to reduce their US tax bills and force them to ramp up premiums for consumers by billions of dollars a year.
- The tax bill is a victory of domestic US insurers incl. Allstate, Berkshire Hathaway and Travelers, which argued that their international rivals – especially in Bermuda – had an unfair tax advantage. The Coalition for American Insurance said the package “helps to close the tax haven loophole in the current tax code that unfairly rewarded the transfer of profits and jobs overseas”.
- The changes will impose a tax on premiums that US subsidiaries pay to their parent companies overseas. The premiums will be taxed at 5% next year, rising to 10% in 2019 and 12.5% in 2026.
- Domestic US companies complain the structures targeted by the reforms are designed to avoid taxes on business their foreign rivals conduct in the US. International insurers counter that there are sound non-tax reasons for such arrangements and that they help spread risk globally.

5. Future ETR – the impact drivers

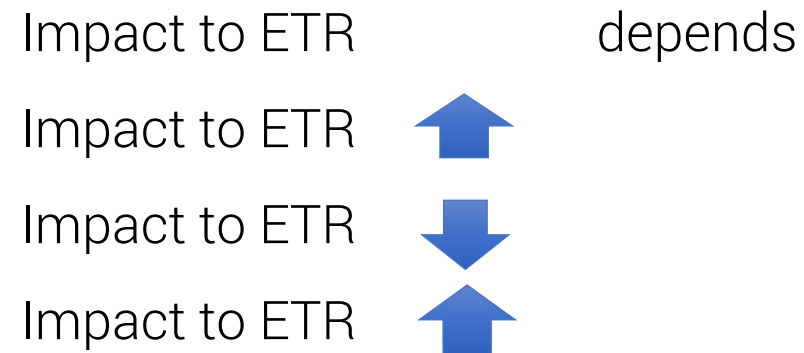
One – Off's (tax rate goes from say 40% to 21%)

- Net DTA
- Net DTL
- Reserves (for US Co's)



Future Profits

- Territorial Tax System (Hybrid System)
- GILTI (US Outbound)
- FDII (US Outbound)
- BEAT (UD Inbound)



5. Rules & concepts – the impact drivers

Major Elements of International Tax Reform

- The 2017 Act reflects reforms perceived as appropriate by the U.S. Congress from a global competitiveness standpoint and implementation of its version of the BEPS Actions, especially Actions 8 – 10. The reforms may seem unilateral in nature, as do the reforms adopted or proposed throughout the world – including the U.K. and Australia DPT; the equalization levy (on, initially, advertising expense relating to digital activities); EU proposed reforms; and the variety of digital regimes under active consideration throughout the world.
- The Act has elements of coordination with evolutions in other countries, incentives for domestic economic activity, sharing of deemed non-routine returns earned in other countries, and penalization of U.S. tax base erosion
 1. Move to Territorial Tax System (Hybrid System)
 - a. Deemed Repatriation of Post-1986 E&P

5. Rules & concepts – the impact drivers

2. Taxation of Intangible Income:
 - a. GILTI (sharing of non-routine, penalization)
 - b. FDII (incentive for domestic investment)
3. Base Erosion Anti-Avoidance Tax (“BEAT”)

5. Territorial Tax System

- The U.S. follows a global trend toward a domestic territorial system, at least in part as the structure of many of the existing subpart F provisions is retained
- New Section 245A – Dividends received deduction
- 100% deduction for foreign portion of dividends received by domestic C-corporation from specified 10%-owned foreign corporations
- No foreign tax credit available for foreign tax paid or accrued
- Deduction not available for hybrid dividends; CFC to CFC hybrid dividends treated as subpart F income
- Holding period requirement
- Effective for distributions made after December 31, 2017

5. Transition Tax - Deemed Repatriation



- Amends Section 965 to increase subpart F income of a specified foreign corporation (SFC) in its last taxable year beginning before January 1, 2018 (transition year) by its pro rata share of the deemed repatriation amount
- An SFC is a controlled foreign corporation (CFC) or any foreign corporation with at least one 10% U.S. shareholder (includes domestic corporations, partnerships, S corps, trusts, estates, and U.S. individuals that own 10% of the voting power)
- Deemed repatriation amount is the greater of such foreign corporation's post-1986 deferred foreign income as of (i) November 2, 2017 or (ii) December 31, 2017 and excludes income previously subject to U.S. tax
- Deemed repatriation amount is unreduced by dividends distributed during the transition year other than dividends distributed to another SFC

5. Transition Tax - Deemed Repatriation

- Actual inclusion with respect to a SFC is reduced by an allocable amount (if any) of the U.S. shareholder's aggregate foreign E&P deficit with respect to other SFCs
- E&P deficit of an SFC determined as of November 2, 2017
- A net E&P deficit of one U.S. corporate shareholder can offset a net positive amount post-1986 deferred foreign income of another U.S. corporate shareholder that is part of the same affiliated group
- U.S. shareholder is taxed at reduced rates (as compared to prior law) on its mandatory inclusion
- The portion of the inclusion attributable to the U.S. shareholder's aggregate foreign cash position is taxed at 15.5% and the remaining portion is taxed at 8%
- **Transition tax rates achieved by allowing a deduction against the mandatory inclusion**
- Payment options include election to pay tax liability in installments over 8 years

5. Taxation of Intangible Income – GILTI/FDII

- Amounts in Excess of Deemed Tangible Income
- Deemed Tangible Income based on Return on Tangible Assets
- Tangible Assets = Qualified Business Asset Investment (“QBAI”)
- QBA = Assets used in a trade or business
 - Depreciation Allowable under S. 167
 - Tax Basis determined under S. 168(g) ADS
- Excess Return is anything > 10% return on QBAI
- CFC with Global Intangible Low-Taxed Income (“GILTI”)
- U.S. with Foreign-Derived Intangible Income (“FDII”)

5. Global Intangible Low-Taxed Income (“GILTI”)



- New Subpart F Category/Separate FTC Basket
- **GILTI = Net CFC tested income – Net deemed tangible income return**
- Net CFC tested income = tested income – tested loss
- Aggregate of such U.S. shareholder’s pro rata share of the “tested income” of each of its CFCs for such taxable year over the aggregate of such shareholder’s pro rate share of the “tested loss” of each of its CFCs for such taxable year
- Tested gross income **excludes**:
 - CFC’s subpart F income
 - any gross income excluded from foreign base company income under high-tax exception,
 - any dividend received from a related person,
 - any item described in Section 952(b), and
 - any foreign oil and gas extraction income

5. Global Intangible Low-Taxed Income (“GILTI”)

- Net deemed tangible income return = 10% of QBAI – Certain interest expense
- QBAI equals the CFC’s average aggregate adjusted bases for specified tangible property during the taxable year
 - Measured quarterly
 - Adjusted basis determined under Section 168(g) ADS
- Impact on C-Corporations
 - Deemed Paid FTC x 80%
 - 100% Section 78 Gross-up
- Impact on Pass-thrus?

5. Foreign-Derived Intangible Income (FDII)

- FDII is calculated by applying a complex set of formulas and definitions that ultimately measure the extent to which the domestic corporation's income in excess of its deemed tangible income (10% x QBAI, increasing to 15.625% after 2025) is attributable to:
 - the sale of property (including licenses and leases) to foreign persons for use outside the U.S. or
 - the performance of services for foreign persons or with respect to property outside the U.S. (i.e., its foreign-derived deduction eligible income)
- Income of the domestic corporation is not taken into account to the extent it is Subpart F income, GILTI, financial services income, a dividend received from a CFC in which the domestic corporation is a U.S. shareholder, domestic oil and gas extraction income, and foreign branch income

5. Deductions for FDII and GILTI

- Deduction for C-Corporations
 - 37.5% for FDII (reduced to 21.875% after 2025)
 - 50% for GILTI (reduced to 37.5% after 2025)
 - Includes Section 78 gross-up
- FDII subject to 13.125% effective tax rate (increased to 16.406% after 2025)
- GILTI subject to 10.5% effective tax rate (increased to 13.125% after 2025)
- Limitation based on taxable income
 - Pro rata reduction of deduction

5. GILTI Example

CFC1
 Gross Income \$1500
 Deductions \$500
 Taxes \$100
 Tangible Assets \$1000
 No Subpart F

CFC2
 Gross Income \$100
 Deductions \$0
 Taxes \$10
 Tangible Assets \$0
 No Subpart F

Net CFC Tested Income: \$900 + \$90 = \$990

CFC1 Tested Income - \$900
 \$1500 Gross Income
\$600 Alloc Deductions/Taxes
 \$900

CFC2 Tested Income - \$90
 \$100 Gross Income
\$10 Alloc Taxes
 \$ 90

GILTI: \$990 - \$100 (\$1000 + \$0 Tangible Asset Basis x 10%) = \$890

US Tax Calculation

Inclusion % - $\$890/\$990 = 89.90\%$
 Aggregate Foreign Taxes - $\$100 + \$10 = \$110$
 Deemed Paid Credit – $80\% \times 89.90\% \times \$110 = \$79.11$
 §78 Gross-up – $100\% \times 89.90\% \times \$110 = \$98.89$

New Section 951A Inclusion - $\$890 + \$98.89 =$	\$988.89
New Section 250 Deduction – $50\% \times \$988.89 =$	\$494.45
Net Income Inclusion	\$494.44
US Tax @ 21%	\$103.83
Less: Deemed Paid Credit	\$ 79.11
Residual US Tax	\$ 24.72

Note: The US foreign tax credit position can have a significant impact on the US residual tax burden on GILTI. For example, US NOLs and US expense allocations could result in lower deemed paid credit utilization.

5. FDII Example

Base Assumptions

Sales of goods for use in the US		\$300
Sales of goods for use outside the US		<u>\$500</u>
Total Eligible Revenue		\$800
Cost of Goods Sold		<u>\$400</u>
Gross Profit		\$400
Allocable deductions (including interest)	<u>\$100</u>	
Potential FDII Eligible Income	\$300	

Tangible Assets (QBAI)		\$300
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Step 1 – Determine Deduction Eligible Income (DEI)

Gross Income		\$400
Less: GILTI, Subpart F, Dividends from CFC, etc.	<u>\$ 0</u>	
Adjusted Gross Income		\$400
Less: Deductions allocable to gross DEI	<u>\$100</u>	
DEI		\$300

a)

5. FDII Example (Continued)

Step 2: Determine Deemed Tangible Return

Tangible assets (QBAI)	\$300	
Routine return factor	<u>10%</u>	
Routine return	\$ 30	b)

Assume no interest expense included in allocable deductions

Step 3: Determine Deemed Intangible Income (DII)

DII = DEI – Routine Return	\$270	a) – b)
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Step 4: Determine Ratio of FDDEI to DEI

Foreign revenue	\$500	
Cost of goods sold	<u>\$250</u>	
Gross profit	\$250	
Allocable deductions	<u>\$ 62.5</u>	
FDDEI	\$187.5	d)
FDDEI/DEI Ratio	62.5%	d) /a)

5. FDII Example (Continued)

Step 5: Determine Foreign Derived Intangible Income (FDII)

Determine Tentative FDII (DEI x FDDEI/DEI) \$168.75

Step 6: Determine FDII Deduction

FDII Deduction % 37.5%

FDII Deduction 63.28

Note: FDII deduction may be reduced if taxable income limitation applies.

Tax Computation

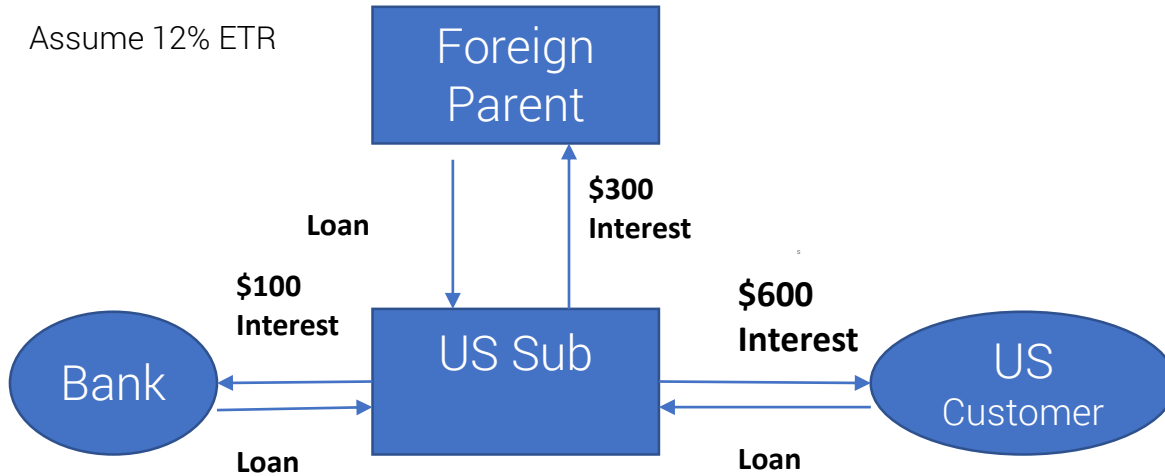
Taxable Income (before FDII deduction)	\$ 300
FDII Deduction	\$ 63.28
Adjusted Taxable Income	\$236.72
Tax Rate	21%
Total Tax	\$ 49.71
US ETR	16.57%

5. Base Erosion Anti-Abuse Tax (BEAT)

- Base Erosion Minimum Tax Amount = excess (if any) of
 - 10% (5% for 2018) x Modified Taxable Income, over
 - Regular taxable income (as adjusted)
- Modified Taxable Income – adds back Base Erosion Benefits
- Base Erosion Benefits – foreign related party payments (interest, royalties, services and deductible amounts associated with acquisition of depreciable/amortizable property) COGS not included in base erosion benefits.
- Applies to domestic corporations (other than S Corps, RICs, or REITs) that are part of an MNE group that has:
 - \$500 million of annual domestic (including ECI amounts earned by foreign affiliates) gross receipts (over a three-year averaging period)
 - Base erosion percentage of at least 3% (or 2% in the case of a bank or registered securities dealer) .
- The intended impact of the provision is to impose a rough 50-50 profit split on such base erosion payments (slightly less since the maximum rate was finalized at 21%), so that other countries could tax the remainder. This result is based on a variety of elements from a logic standpoint

5. BEAT Example

Assume 12% ETR



Base Erosion Tax Benefit: \$300

Safe Harbor: US Sub base erosion %: 75%

$$\frac{\$300}{\$400} = 75\%$$

Base erosion minimum tax amount (BEMTA)

Modified taxable income (MTI) x 10% - Regular tax liability (RTL)

MTI = \$500

\$600	Gross income
<u>-\$100</u>	Deductions (without base erosion payments)
\$500	MTI

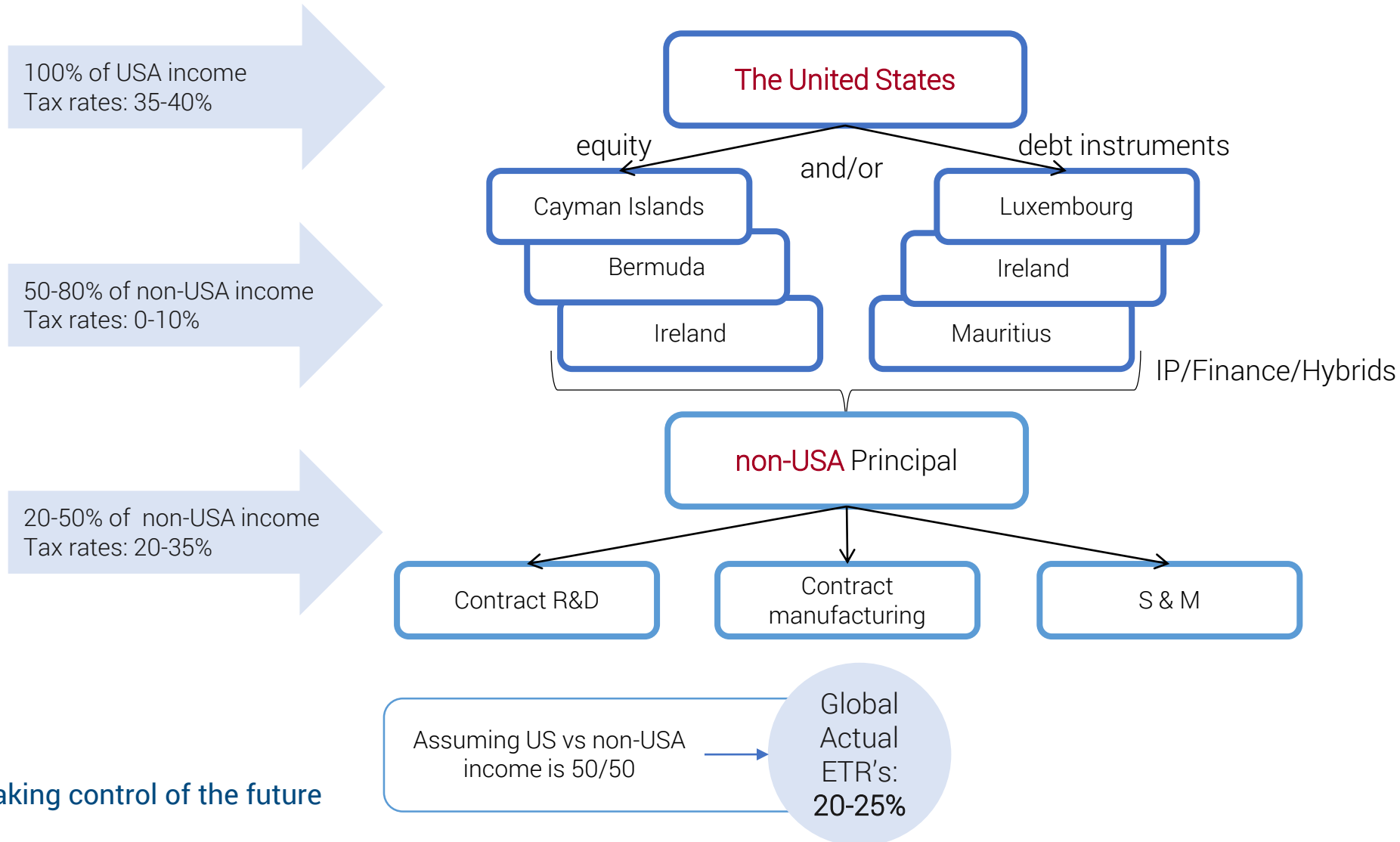
RTL = \$42

\$600	Gross Income
<u>-\$400</u>	Deductions
\$42	
\$200	
X 21%	Corp Tax Rate
\$ 42	RTL

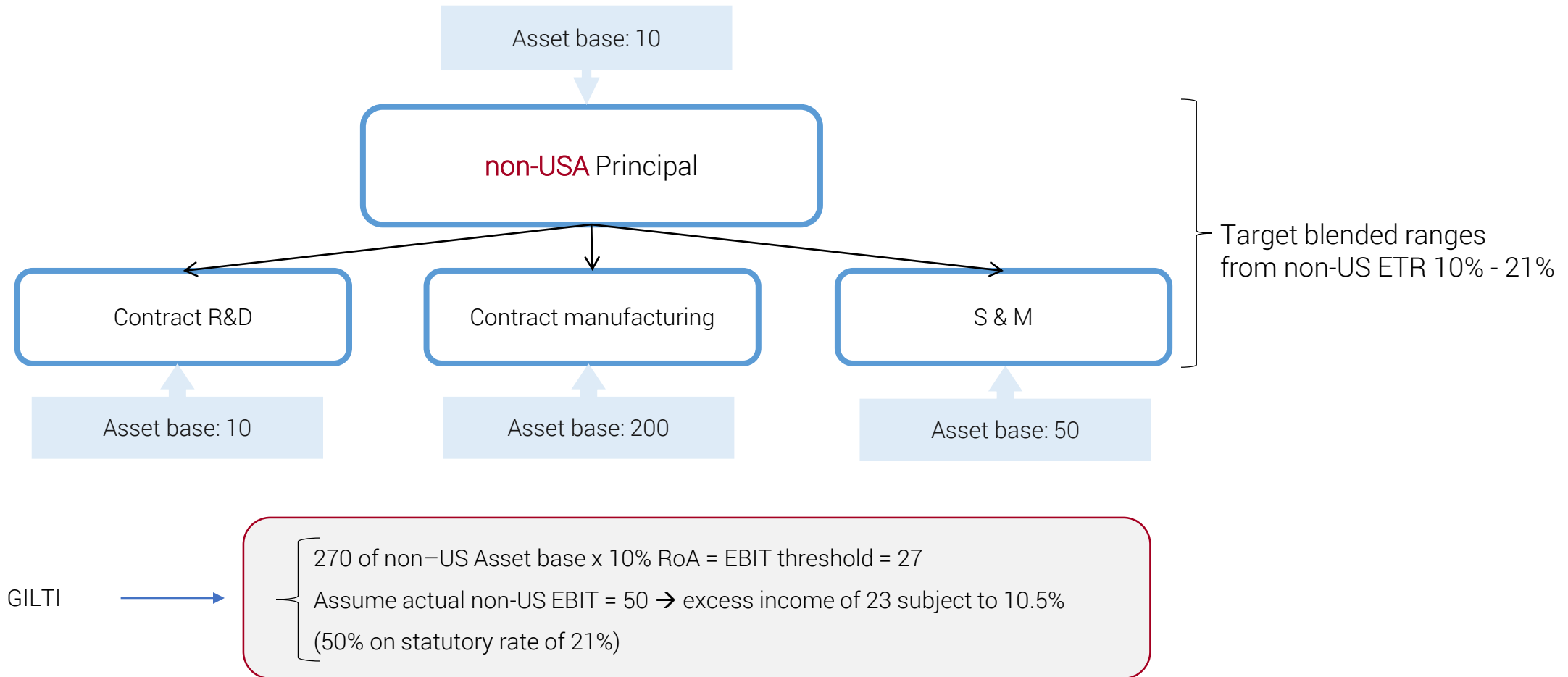
Residual US Tax

\$500 x 10%	= \$50
Less: RTL	=
BEMTA	= \$ 8

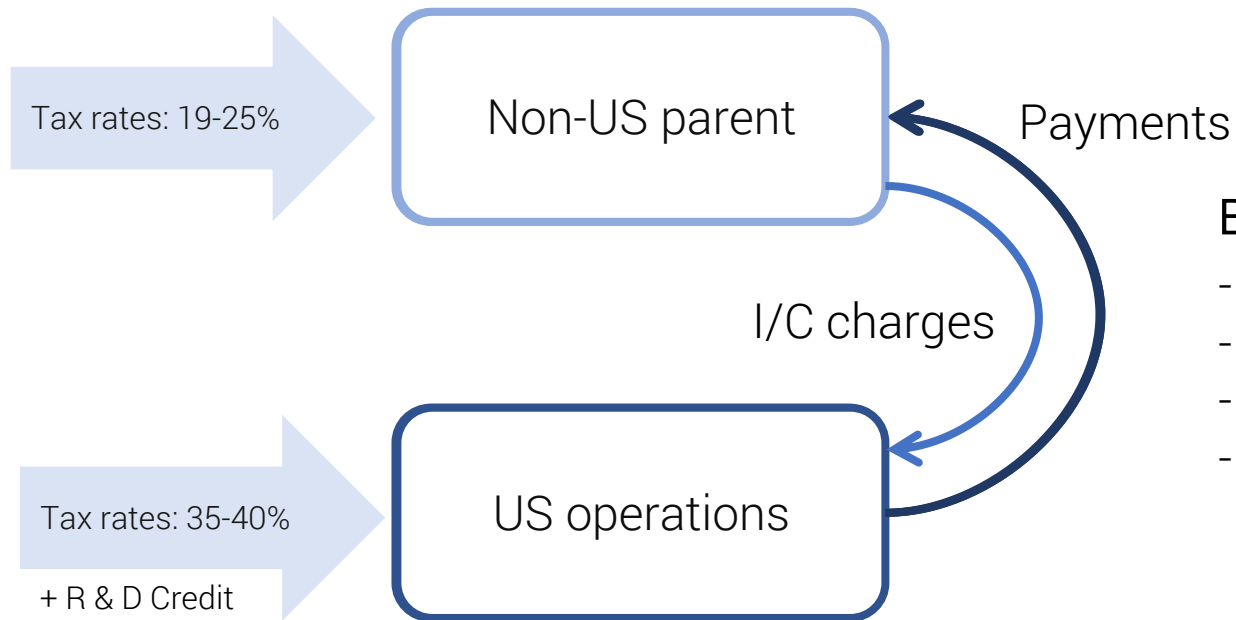
6. Outbound – “as is”



6. Outbound – future structuring model



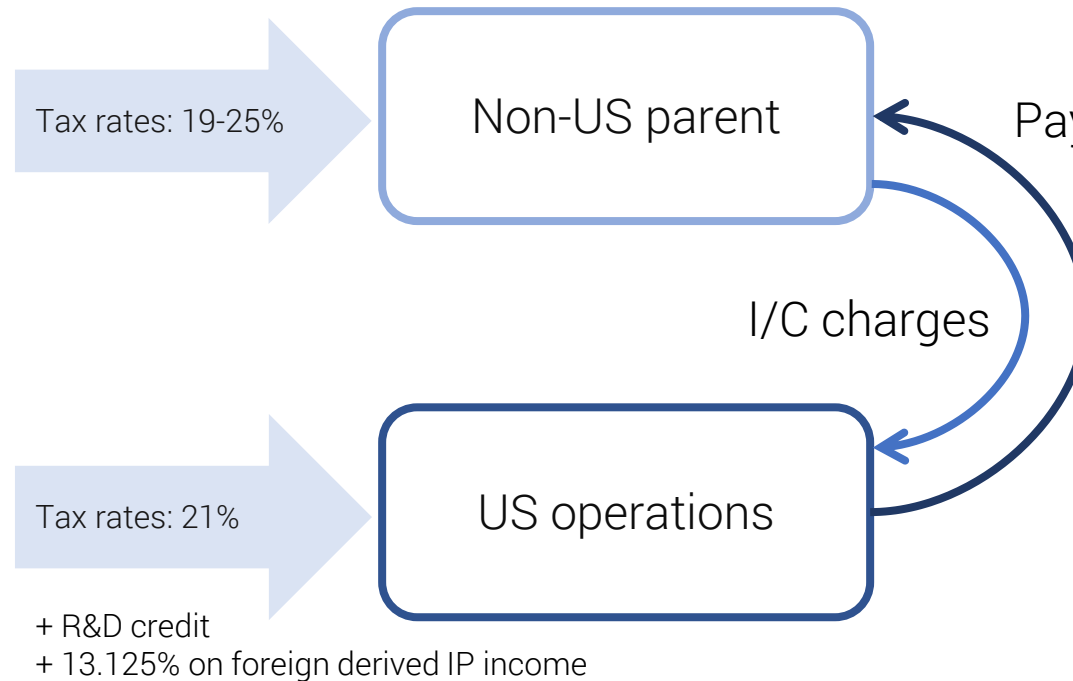
6. Inbound – “as is”



Base eroding payments

- I/C payments
- e.g. financing, royalty, services, goods
- Example:
- I/C charges deductible at 35-40% and taxable at 19-25% (tax rate arbitrage)

6. Inbound – future structuring model



Base eroding payments

- Defined by all I/C payments except COGS excluded
- Also includes annual depreciation/amortization on acquisitions of capital assets
- Rate reduction coupled with BEAT will reduce incentive to shift deductions to US sub.

7. Practical implications

The cumulation of BEPS / Unilateral Actions / EU Proposals / ATAD / Source Country Demands and US Tax Reforms being implemented does significantly

- i. Impact the ETRs of inbound and outbound multinationals
- ii. Create new opportunities due to tax policy incentives (low rates, FDII/patent box)
- iii. Require a reset on business models and their 2018 onwards tax consequences
- iv. Drive one big global & synchronized tax compliance exercise. i.e. determining your CIT / MF/LF / CbcR / local TP form filing deadlines becomes a “must” – Checklist follows

8. Working Group Checklist

- **Formation of Working Group (internal and external)**
 - Role of attorney-client privilege in the process?
- **Financial Accounting Due Diligence**
 - Current Global ETR Plan (goals, objectives, building blocks)
- **CbC Documentation**
 - Evaluate CbC, master and local files
 - Risk assessment of ETR building blocks
 - Evaluation on a system profit or profit-split basis
- **Modeling**
 - Develop value chain analysis of pertinent business lines
 - Re-evaluate the Global ETR Plan
- **Revisit building blocks in view of the modeling**
 - Identify risks to be addressed
 - Consider potential risk-mitigation strategies
 - Risk of tax authority challenge
 - Likelihood of successfully being able to defend a challenge

8. Working Group Checklist (2)

- Develop recommendations as to ways forward with respect to each issue
 - Do nothing at the present time (wait and see how pertinent tax or related matters evolve – i.e., patience)
 - Incrementalize (e.g., develop means of strengthening problem areas or undertaking new business opportunities in a different structure)
 - Full scale restructuring
- **Impact of Potential Restructuring**
 - Business lines or chains
 - Income tax
 - Consumption tax
 - TP
 - Exit or restructuring taxes
 - Existing examinations or pending disputes
 - Tax treaty elements
 - Anticipation of financial auditor review
 - Update Modeling as appropriate

8. Working Group Checklist (3)

- Internal management review and approval
- Implementation
- Home country tax authority coordination?
 - New or existing APAs
 - Approach home country tax authority for a global tax agreement (broader than an APA) to address potential double or multiple taxation, perhaps in consideration for commitment for location of economic activities?

Questions?



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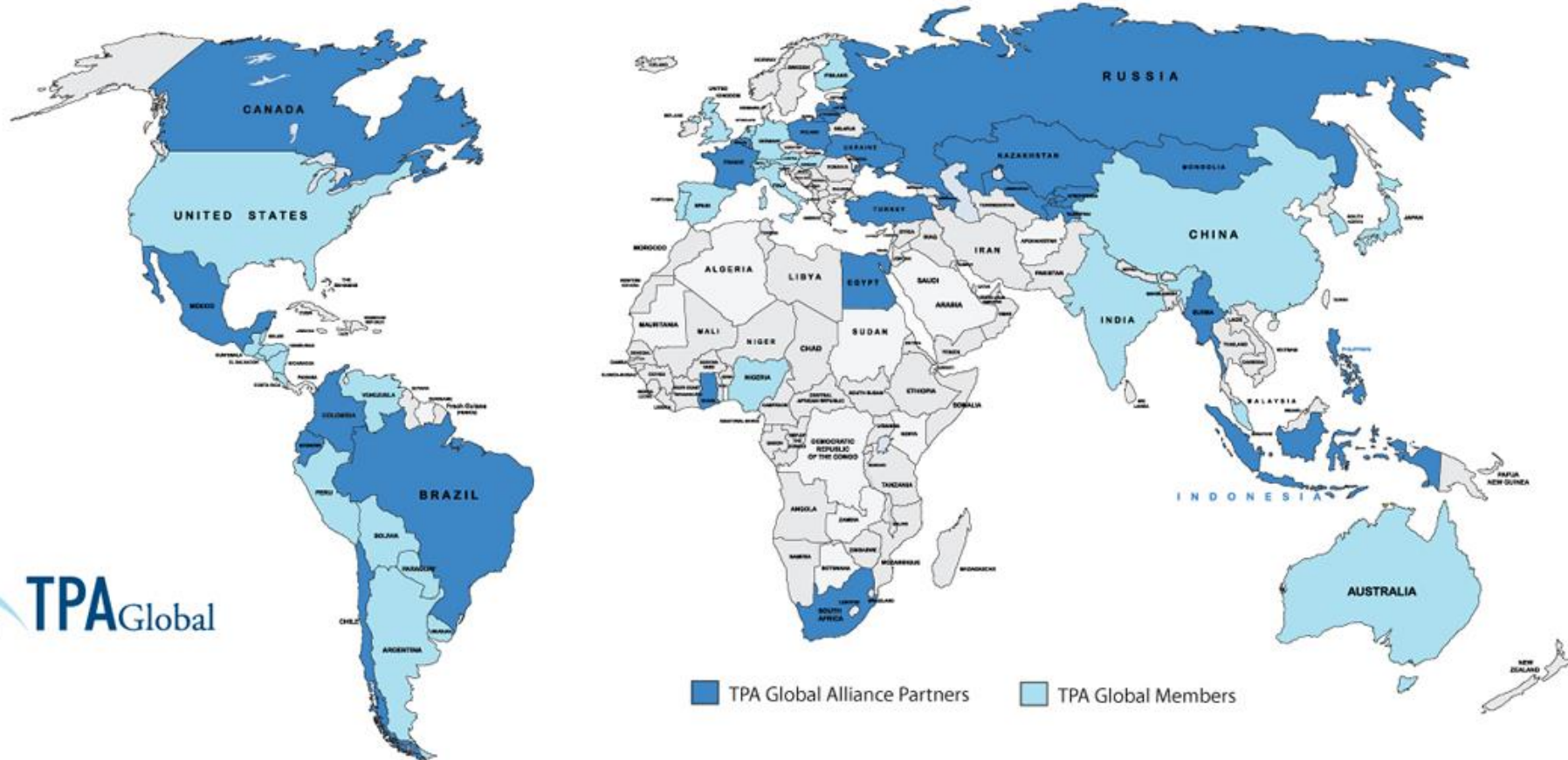
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