Client Alert

May 2018

U.S. Subsidiaries of Foreign Parents Should Evaluate the Consequences of Various Tax Provisions Enacted Under the Tax Cuts and Jobs Act

As a result of newly applicable changes to the Internal Revenue Code (the "Code") under the Tax Cuts and Jobs Act, P.L. 115-97, (the "Act"), U.S. subsidiaries of foreign parents may need to reevaluate their onshore U.S. capital structures and business models. Important changes made by the Act include (i) the introduction of the base erosion and anti-abuse tax (the "BEAT"), (ii) newly imposed limitations on deductions for certain interest or royalty amounts paid or accrued pursuant to hybrid transactions or with hybrid entities, and (iii) modifications to business interest deduction limitations.

BEAT – Code Section 59A

New Code section 59A imposes a new annual minimum tax, commonly referred to as the BEAT, which can increase substantially U.S. taxes for certain U.S. taxpayers. The BEAT targets U.S. taxpayers who make payments to related foreign parties. Not all U.S. corporations are subject to the BEAT.

Application of the BEAT. The BEAT applies to corporations (excepting REITs, regulated investment companies, and S corporations) with annual gross receipts (determined over a three year period) of at least $500 million. For the BEAT to apply, a taxpayer's "base erosion percentage" must meet or exceed 3 percent (2 percent for certain banks and registered securities dealers). The base erosion percentage is the amount of the taxpayer's taxable year "base erosion tax benefits" (defined below) divided by the sum of the taxpayer's deductions allowed in such taxable year.

The BEAT Tax Liability. The BEAT will increase an applicable taxpayer's U.S. tax liability to 10 percent (5 percent for taxable years beginning in 2018 and 12.5 percent for taxable years beginning in 2026 and after) of its "modified taxable income." "Modified taxable income" means a taxpayer's taxable income determined without regard to "base erosion tax benefits", *i.e.*, otherwise-allowed (i) amortization or depreciation allowances for amounts paid or accrued to a related foreign person with respect to property acquired from that related foreign person, and (ii) certain deductions associated with amounts paid to related foreign persons. Notable exclusions from base erosion tax benefits include certain fees paid in service transactions and cost of goods sold ("COGS").

Because of the manner in which the BEAT is calculated, U.S. corporations that take advantage of material general business credits in determining their regular U.S. tax liability will almost certainly pay increased U.S. taxes because of the BEAT if the BEAT applies to them. Non-U.S. owners of U.S. subsidiaries should consider planning tactics to minimize the adverse consequences of the BEAT by precluding its application. Such tactics might include:

- Substituting unrelated third party debt for related party debt in U.S. debt financings to decrease base erosion tax benefits;

© 2018 Hunton Andrews Kurth LLP

- given the lower 21 percent U.S. corporate tax rate, increasing the size of its U.S. subsidiary's tax base to reduce its base erosion percentage; and
- structuring payments (other than interest) to related parties as payments that are not base erosion tax benefits to the maximum extent possible.

Hybrid Entities and Transactions – Code Section 267A

Newly added Code section 267A disallows deductions for certain royalty or interest payments made by or to a hybrid entity or pursuant to a hybrid transaction. Specifically, Code section 267A applies to a royalty or interest payment paid or accrued to a related party if such payment is not included in the recipient's income or if the recipient is allowed a deduction for such payment pursuant to the tax laws of the country in which the recipient resides or is subject to tax. A hybrid transaction is a transaction that, under U.S. tax law, is treated as an interest or royalty payment but is not treated as such under the tax laws of the country where the recipient resides or is subject to tax. A hybrid entity means an entity treated as fiscally transparent under U.S. tax law but not under the tax laws of the country where the recipient resides or is subject to tax, or vice versa.

The addition of Code section 267A requires a U.S. subsidiary owned by one or more foreign shareholders to know the foreign tax treatment of its foreign affiliated entities to whom interest or royalties are paid by the U.S. subsidiary. Section 267A, if applicable, permanently disallows the interest or royalty deductions to which it applies.

Business Interest Deductions – Code Section 163(j)

Even if deductions of interest payments are not disallowed by Code section 267A, Code section 163(j) may limit those deductions. The Act broadened the limitations imposed on interest deductions for all U.S. taxpayers. For a given taxable year, Code section 163(j) limits deductions with respect to business interest to the sum of (i) business interest income (interest included in the gross income allocable to a trade or business), (ii) 30 percent of the "adjusted taxable income," and (iii) floor plan financing interest (relating to acquiring motor vehicles held for sale or lease). "Adjusted taxable income" generally means taxable income "computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any net operating loss deduction under section 172, (iv) the amount of any deduction allowed under new section 199A (regarding qualified business income for pass throughs), and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion."

If, in a given taxable year, business interest is disallowed as a deduction under section 163(j), the amount disallowed is carried forward and treated as paid in such carryforward years (subject to limitations for partnerships).

The Treasury Department and the IRS issued Notice 2018-28, which states their intention to issue regulations that will apply new section 163(j) at the consolidated group level, ignoring intercompany transactions in applying the limitation. As a result of these changes, a U.S. subsidiary whose onshore U.S. capital structures include substantial amounts of debt (whether or not such debt is related party debt) should consider whether the subsidiary will be able to deduct all of its interest when computing its U.S. income tax liability.

© 2018 Hunton Andrews Kurth LLP

Contacts

B. Cary Tolley, III
ctolley@HuntonAK.com

Hilary B. Lefko
hlefko@HuntonAK.com

Cecelia Philipps Horner
chorner@HuntonAK.com

Alexander G. McGeoch
amcgeoch@HuntonAK.com

Andrew Feiner
andyfeiner@HuntonAK.com

Kendal A. Sibley
ksibley@HuntonAK.com

© 2018 Hunton Andrews Kurth LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.