U.S. Germany Corridor: Update on U.S. tax reform

December 22, 2017

U.S. tax reform brings major changes that require significant attention

Just before the holidays, President Trump signed the U.S. tax reform bill into law, enacting a broad overhaul of the U.S. tax system. The change in rules is the biggest and most comprehensive experienced in the United States in more than 30 years. Clients in the U.S. Germany Corridor are faced with drastic revisions in U.S. taxation of most domestic and international aspects of their business matters.

With the voluminous and extremely complex new rules, the far-reaching tax and accounting implications of U.S. tax reform should be considered in depth as applicable to the reader's specific facts. Moreover, beyond consideration of immediate consequences, in many circumstances, adjustments to your long-term tax strategy and planning may be warranted.

With this brief update article, we provide cursory summaries of various tax reform provisions (noncomprehensive) that we anticipate are most relevant to the majority of our U.S. Germany Corridor readers, albeit with slightly more of an emphasis on U.S.-inbound taxation issues for German-based multinationals. Additionally, many forthcoming Internal Revenue Service (IRS) notices and U.S. Treasury regulations are expected to clarify and modify various features of the new rules, and there is even potential for a technical corrections bill. Accordingly, continued monitoring of developments on an ongoing basis is important.

We are here to support, and our contact information can be found at the end of this document.

Key areas of relevance

- **Corporate rate reduction.** The U.S. corporate tax rate is reduced from 35 percent to 21 percent, generally taking effect on January 1, 2018.
  - *Traditionally, due to the historically high U.S. corporate tax rate, many German inbound companies looked to push deductible costs into the United States and keep profitable activities offshore to the extent feasible. Those planning techniques and assumptions may no longer be desirable with the U.S. corporate tax rate being reduced below the German tax rate (combined corporate income tax and trade tax).*
- **Expensing.** Immediate full expensing is permitted for certain property (not limited to original use) placed in service after September 27, 2017 and before January 1, 2023, subject to a phase-out for property placed in service after 2022.
- **Corporate Alternative Minimum Tax (AMT) Repeal.** The corporate AMT is eliminated, effective for taxable years beginning after December 31, 2017.
- **Net Operating Loss (NOL) Changes.** NOLs arising in taxable years beginning after December 31, 2017 can be carried forward indefinitely but not carried back for most industries. However deductions of such NOLs are capped at 80 percent of taxable income for the year, computed without regard to the NOL deduction.
- **Interest Expense Limitation.** For taxable years beginning after 2017, "net business interest expense" deductions are limited by substantially modifying the current earnings stripping rules (i.e., section 163(j)).
  - The deduction is limited to business interest income plus 30 percent of adjusted taxable income (ATI). Of importance, ATI includes an addback of depreciation and amortization deductions only through tax years beginning before January 1, 2022; thereafter, such deductions are no longer excluded from the computation of ATI, resulting in a much narrower limitation.
  - In contrast to the current earnings stripping rules which are generally applicable to related-party interest or interest paid on a loan guaranteed by a foreign related party, the new rules apply to all interest expense whether payable to a related or unrelated party, and regardless of whether the unrelated lender is subject to U.S. taxation on its interest income.
  - Disallowed business interest may be carried forward indefinitely.
  - In previous iterations of the bill, there had been a proposed worldwide ratio/disproportionate U.S. interest expense limitation, too. However, that provision was deleted from the final draft.
  - *Given the historical high rate of U.S. corporate tax and resulting arbitrage on intercompany interest payments, debt financing has been a valuable tax planning measure in the German-U.S. context. However, with a lower U.S. rate and stricter limitations on interest deductibility, this may no longer be the case (noting there may be many other reasons that still make debt financing desirable nevertheless).*
- **Section 199.** Section 199 (deduction for domestic production activities) is repealed, effective for tax years beginning after December 31, 2017.
- **Deductions Relating to Hybrid Arrangements.** For taxable years beginning after December 31, 2017, deductions are denied for interest or royalties paid to related parties if paid pursuant to hybrid transactions, or by, or to, a hybrid entity (collectively, a Hybrid Financing).
  - Specifically, deductibility is disallowed in a Hybrid Financing if, under the related payee's residence country tax rules, (i) there is no corresponding inclusion by the related payee, or (ii) the related payee is allowed a deduction with respect to the amount.
  - *Many German inbound clients have historically used hybrid arrangements as a tax planning technique to finance their U.S. operations. As a result of the EU's directive under BEPS as well as developments under German domestic law, many of these structures have been unwound recently. While this new U.S. rule may result in more hybrid arrangements having to be unwound, there may be some hybrid structures that are not within the scope of this rule. However, broad regulatory authority is granted for the Treasury Department and the IRS to broaden the scope under this provision, and promulgation of regulations under such authority remains an area of uncertainty.*
- **BEAT Tax.** A new base erosion minimum tax (commonly referred to as the BEAT) is imposed for base erosion payments paid or accrued in tax years beginning after December 31, 2017.
  - The minimum tax is assessed against a taxpayer's "modified taxable income," generally determined without regard to deductions or other tax benefits arising from base eroding payments made to related foreign persons.
  - Broadly, the BEAT creates a minimum tax rate (generally, phased in: 5 percent for 2018, 10 percent from 2019 through 2025, and 12.5 percent thereafter) on certain deductible payments made to related foreign parties (e.g., any 25 percent shareholder and related persons thereto).
  - Banks and registered securities dealers are subject to a 1-percentage point higher BEAT rate (or 6 percent for 2018, 11 percent from 2019 through 2025, and 13.5 percent thereafter).
  - The targeted base erosion payments are deductible amounts paid or accrued to foreign related parties. In most circumstances, payments that relate to cost of goods sold are not included as base eroding payments. There are various exceptions.
  - The BEAT applies to corporations having average annual gross receipts of at least $500 million over a three-year testing period, if at least 3 percent (2 percent for banks and registered securities dealers) of the corporation's tax deductions are attributable to base eroding tax benefits.
- **Foreign Partner Taxation on Sale of Partnership Interest.** For transactions on or after November 27, 2017, the new rules would require a look-through approach for taxing gain on the sale of a foreign partner's interest in a partnership engaged in a U.S. trade or business (overriding the recent Tax Court holding in *Grecian Magnesite Mining v. Commissioner*). The sale or exchange of such a partnership interest would be treated as effectively connected with a U.S. trade or business (ECI) and therefore subject to U.S. net basis taxation to the extent the selling foreign partner would have had ECI if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange. The purchaser is required to withhold for sales of such partnership interests beginning in 2018.
- **Participation Exemption.** A new 100 percent deduction is provided for eligible foreign source dividends received from 10 percent-owned foreign corporations by qualifying U.S. corporate shareholders. Dividends eligible for this 100 percent deduction are limited to earnings and profits attributable to a routine return earned by a 10 percent-owned foreign corporation (see GILTI discussion below).
- **Mandatory Repatriation – Taxation of Historical Foreign Earnings.** As a transition to a partial participation regime, deemed repatriation of previously untaxed historical earnings will be subject to taxation during the "specified foreign corporation's" last taxable year beginning before January 1, 2018. A 15.5 percent rate would apply to earnings attributable to liquid assets, and an 8 percent rate would apply to earnings attributable to illiquid assets. The resulting federal income tax may be paid over an eight-year period of increasing (8 percent to 25 percent) annual installments, with possible acceleration upon the occurrence of certain triggering events.
- **Expansion of Subpart F (antideferral rules regarding foreign subsidiary earnings) Applicability.** The new provisions would make it easier for many companies, particularly inbounds, to be subject to the subpart F (antideferral) rules. More specifically:
  - Constructive ownership rules are expanded so that a U.S. corporation may be treated as constructively owning foreign stock held by its foreign shareholder. U.S. tax reporting rules would be applicable to CFCs created by this provision, absent guidance from the IRS stating otherwise.
  - Additionally, the definition of United States shareholder is expanded to include a 10 percent value test (in addition to the current 10 percent vote test).
- **Global Intangible Low-taxed Income (GILTI) – New Category of U.S. Taxation of Foreign Earnings.** The new rules create a minimum tax on a U.S. shareholder's portion of its foreign subsidiaries' GILTI. Effectively, the GILTI rules impose current taxation on a U.S. shareholder's share of a CFC's non-subpart-F income in excess of a "routine return" (at an effective U.S. tax rate of 10.5 percent prior to a 2026 phase-down). This functions as an additional antideferral measure regarding foreign subsidiary earnings. The rule has effect for taxable years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders ending with or within such years.
- **IP Incentives – "Foreign Derived Intangible Income."** In conjunction with the GILTI rules described above, through a deduction mechanism the rules provide a 13.125 percent effective tax rate on excess returns earned directly by a U.S. corporation from foreign sales (including licenses and leases) or services, which would increase to 16.406 percent starting in 2026.
  - *This element of the rule is intended to incentivize development of new IP in the United States and onshoring of existing IP to the United States. German inbound clients should consider the implications under their CFC (and other applicable) rules.*
- **Research and Development (R&D) Credit.** The R&D credit is generally retained, but beginning in 2022 specified R&D expenses must be capitalized and amortized over a 5-year period (increased to a 15-year period if the relevant research is conducted outside the United States).
- **Changes to Foreign Tax Credit Rules.** The new rules modify the foreign tax credit rules in various ways for taxable years of foreign corporations beginning after December 31, 2017.

Key issues and recommended action steps

- As a first step, most companies will need to address the many book and tax implications regarding tax reform. For instance, determination of various tax attributes may be needed in short order (e.g., earnings and profits measurement as relevant to mandatory repatriation). Additionally, deferred tax assets, deferred tax liabilities, valuation allowances, etc., likely need to be readjusted for book purposes based on the many applicable changes.
- From a more long-term perspective, it is recommended to reconsider the general assumptions underlying your structure and approach to U.S. tax planning afresh. In many circumstances, revisions may be appropriate.
- To understand the implications of tax reform on your specific company, modeling is important. Additionally, modeling would likely highlight where changes may be desired based on tax inefficiencies/opportunities. KPMG has developed a robust tax-reform model that can be used for this purpose.
- As noted above, additional changes are likely to come and such changes may be significant. Therefore, ongoing monitoring for updates to the rules is necessary. Please see some links below to resources that can help you monitor developments.
- Existing debt financing structure and hybrid arrangements should be reviewed to understand viability under U.S. tax reform (as well as other developments). Where issues are found, are mitigation strategies available?
- Should you alter your IP holding structure, and consider migrating IP to the United States or elsewhere? The stakes are high, and it is possible for the rules to change in this regard. However, there may be a valuable opportunity presented.
- Do you have BEAT tax exposure? With the reduced corporate tax rate, the BEAT tax, and various expense limitations (among other provisions), does your supply chain still make sense? Consider whether adjustments may result in increased global efficiencies.
- For various reasons (e.g., accelerating deductions before the tax rate reduction, deferring income into periods with the lower rate, controlling implications of GILTI and mandatory repatriation taxation, etc.), you may consider making some changes in accounting methods and/or taxable year-end. Such changes can be very valuable, but there is not a long window of time before the opportunity is gone.
- As you consider M&A transactions, the assumptions that would typically underlie your deal model as well as evaluation of tax attributes and risks should be revised, consistent with tax reform. Additionally, asset deals may become increasingly desirable given expensing permissibility.
- Are more non-U.S. entities in your structure subject to U.S. reporting or taxation? Determine impact of new CFC stock attribution rules, particularly for groups with U.S. "sandwich" structures.

To learn more

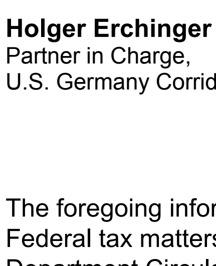
The text of the bill as signed by President Trump is available here.

For a more detailed summary, please refer to the KPMG Booklet on New Tax Law.

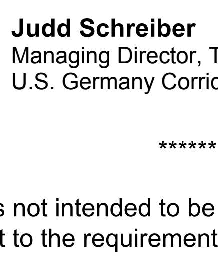
Additionally, for more materials and ongoing updates, please refer to KPMG Institute's Tax Reform Portal. You can register to receive regular updates with a KPMG TaxNewsFlash subscription here.

If you have any questions, please contact Judd Schreiber.

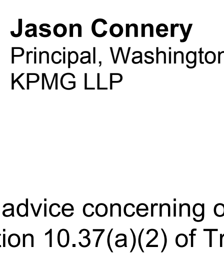
Thank you.



Holger Erchinger
Partner in Charge,
U.S. Germany Corridor



Judd Schreiber
Managing Director, Tax
U.S. Germany Corridor



Jason Connery
Principal, Washington National Tax,
KPMG LLP

****