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Tax

Regulation

Globe

US tax reform one year in

Cutting through the complexity to seize the opportunity

In December 2017, US lawmakers enacted the Tax Cuts and Jobs Act (TCJA), the country's biggest overhaul of tax legislation for a generation – you'll have to go back to 1986 for anything as far-reaching. The impact on corporate earnings and investment plans are appearing significant and further opportunities are unfolding. However, a year on from being passed in Congress, the legislation is still subject to considerable interpretation.

The process of turning the TCJA into binding regulations continues with around 2,000 pages to date and possibly the same to come. It may be at least another 12 months before the fine print of the rules is complete and another year after that before we know the full impact.

And all those hundreds of pages of regulation have created a labyrinth of fine print, ambiguity and potentially unintended consequences. For multinational enterprises (MNEs) based or with operations in the US, the challenge is how to cut through the complexity to identify and realise the opportunity. You also face the challenge of more complex compliance demands. How can your business get on track?

Far reaching tax reform

By any measure, the TCJA is a game-changer. The impact reaches beyond tax management to business planning, operating structures and market competition.

The headline shift is the reduction in the US federal corporate tax rate from 35% to 21%. While this monumental cut makes the US rate more competitive, it by no means makes it the lowest in the G7 – for example, the UK rate is currently 19% and due to come down to 17%.[1] Moreover, the TCJA closes a number of exemptions, which may mean that the gain isn't quite as big as the 14% cut would imply.

Just as far-reaching is bringing the US' international tax regime broadly into line with other major economies. The US used to be an outlier by requiring corporations to pay tax on foreign earnings brought back into the US, less a credit for tax paid where the revenue was generated. The US has now moved to a 'quasi-territorial' system, in which tax is paid where the money is made (subject to some guardrails to prevent abuse). This levels the playing field with major international competitors, although as we'll see it's now harder to park profits in overseas subsidiaries or divert income to low tax jurisdictions.

The TCJA has given corporations an opportunity to repatriate funds held abroad free of future US tax (after a transition 'toll tax' payment). Further relief comes from a 'participation exemption' on tax on dividend income from foreign subsidiaries. While such an exemption is another move towards the international centre of gravity of taxation, the US qualification threshold of a 10% stake is noticeably lower than the standard 25%. The exemption doesn't apply to branches, which may prompt a review of such structures.

Foreign Derived Intangible Income (FDII) provides a 37.5% deduction on taxable income from services to entities outside the US – including related parties. The favourable rate has much in common with 'patent box' incentives for research and development (R&D) in other jurisdictions.

Global Intangible Low-Taxed Income (GILTI)

The main counterweight to the territorial system is the GILTI, which is an anti-deferral measure designed to prevent companies from shifting profits on mobile income (eg royalty payments) to low tax jurisdictions by imposing a 13.125% tax floor on tax paid outside the US. If lower, the company would likely be subject to a residual US charge.

The concept of a minimum tax can also be seen in the Base Erosion Anti-Abuse Tax (BEAT), which seeks to deter corporations from making excessive tax-deductible expense payments to foreign affiliates. While some commentators see these measures as a nod towards the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan, there are important differences in approach – a much better comparison would be the UK's Diverted Profit Tax.[2] BEAT has significant implications for transfer pricing, with the risk of double taxation heightened by the lack of a credit for tax paid outside the US on these payments.

The spirit if not the letter of BEPS can also be seen in the TCJA's limits on interest expense deductibility, which could have a significant impact on funding and capital structuring.

Moreover, long-term capital gains rates on carried interest will only apply if a company has been held by a private equity firm for more than three years, an increase from one-year before. If an asset is held for less than three years, carried interest will be treated as a short-term capital gain and subject to standard tax rates.

[1] www.gov.uk – Rates and allowances: Corporation Tax, April 2018

[2] www.gov.uk – Diverted Profits Tax: guidance

Has the reform delivered its objectives?

Boost the economy

The TCJA is designed to boost the US economy and encourage the creation of high paid jobs. Despite the impact of initial one-off charges, earnings have risen, reaching an all-time record in Q3 2018.[3] The Dow Jones Industrial Average and S&P 500 also reached record levels in Q3, but have fallen back since.[4] Unemployment is at the lowest level since the 1960s.[5]

How much of this is down to the tax cuts and whether the gains are sustainable are hard to gauge with any certainty at this stage. What is not in doubt is that a $1.5 trillion tax cut gives US corporations a significant edge when competing with MNEs from other jurisdictions.[6]

Simplify the tax system

The other big objective was to simplify the tax system, though there is little sign of this. The legislative process proceeded at pace – three major rewrites in six weeks – leaving limited time to step back and iron out existing anomalies or tackle problematic areas from scratch.[7] Indeed, the TCJA has added further grey areas and multi-step calculations by imposing one set of highly complex legislation on an already complex set of tax statutes.

There are also outright errors that were not picked up in the legislative review. Further legislation is needed to sort these out, but as the TCJA was drawn up and passed without Democratic involvement, they have little incentive to correct any mistakes. It may therefore be some time before the glitches are dealt with.

With around 2,000 pages of regulations already and probably the same to come, there is a lot of devil in a lot of detail. And even then, the implications are still open to considerable interpretation. Examples include expense allocations within the calculation of the GILTI minimum tax on foreign earnings. Exclusions mean that some businesses that thought they would be exempt have ended up on the wrong side of the tax floor and hence paying residual US tax on foreign earnings.

It's also important to look at the TCJA against the backdrop of significant disruption and change within the international tax system. Parallel developments include the BEPS Action Plan, imposition of higher new tariffs and possible changes following the UK's planned withdrawal from the EU.

As regulations come up for consultation, both US businesses and MNEs operating in the US are busily assessing the implications. Judging by how much is still to be finalised and the experience of the last major reform in 1986, it's likely to be at least two years of technical corrections and regulations before the full ramifications are clear.

[3] www.tradingeconomics.com – United States Corporate Profits

[4] www.wsj.com – Market data center, US stocks overview

[5] www.wsj.com – U.S. Unemployment Rate Falls to Lowest Level Since 1969, 5 October 2018

[6] www.bloomberg.com – Trump Signs $1.5 Trillion Tax Cut in First Major Legislative Win, 22 December 2017

[7] www.grantthornton.com – Tax reform one year later: Winners and losers, 17 December 2018

Four ways to get to grips with the changes and capitalise on the potential opportunities?

1 Update your tax model

The way your entities, transfer pricing and cost-sharing arrangements have been structured from a tax perspective are likely to reflect a system that has now been superseded. How does your operating structure now look from a tax efficiency perspective? Are you still getting the benefits you had before? How can you bring structures and supply chain arrangements up to date?

Related-party transactions and the structures that underpin will need thorough review and possibly significant change. Operational location may also be affected. For example, there could be tax advantages for shifting research and development into the US as a result of the Foreign Derived Intangible Income (FDII) provisions. Although any such movement does of course come with disruption and operational costs. Any movement in intellectual property and intangible income flows also have to be looked at in light of the shift from physical presence (ie bricks and mortar) to economic presence (ie anywhere where value is created including virtual transactions) as the defining feature of a taxable nexus.

2 Re-evaluate capital structure

We're already seeing a greater willingness to deploy capital in the US in search of better returns. The flipside includes re-evaluating the use of debt in light of the limits on interest rate deductibility. For private equity, the treatment of certain leveraged structures may be potentially less favourable than before. Moreover, while before, it was common practice to borrow money in the US and lend this to the rest of the group, the tighter deductibility criteria could mean that it makes more sense to access credit outside the US. The shifting targets in this area are causing taxpayers to align borrowing with profit generating activities.

A similar review of capital structures is likely to be needed by companies in highly leveraged sectors such as energy and mining. On the flipside, they and other plant and machinery-intensive industries may be able to take advantage of the opportunity to deduct 100% of the value of assets on acquisition. This may be a consideration when choosing between stock or asset transaction structures.

3 Make your voice count

If the devil is in the detail, then it's important to work out what proposed interpretations of the legislation mean for your business and have your say as part of the consultation process. This will be ongoing.

4 Work out how to manage the increased compliance demands

The TCJA imposes significant extra demands on data gathering, calculation and filing, much of which needs to be carried out quarterly. If we look at GILTI, for example, your business would need to carry out calculations and returns for every subsidiary. If the amount of information in a US tax return might have been five to six pages per entity, we are now typically looking at 12-15.

Are your systems, processes and controls up to speed? Central co-ordination to evaluate and seek to alleviate unnecessary costs is also important.

On the front foot

The TCJA has the potential to deliver higher earnings and more cash for investment. Yet, there is a lot of hard work required to realise the benefits, along with systematic reviews of systems, technology and processes to ensure compliance.

Whether you're a US-based MNE or you're an MNE with operations in the US, it's important to get on the front foot by assessing the impact on your structures and how you can manage this. It's also important to look at the TCJA as part of a wider review of whether current tax management is fit for purpose, with the US reforms providing the catalyst for possible system modernisation.

If you would like to discuss any of the areas raised, please contact David Sites, Grant Thornton US or your local Grant Thornton adviser.

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